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Decision 88-06-036 June 17, 1988

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of AT&T COMMUNICATIONS OF CALIFORNIA, INC., a corporation, for authority to increase certain intrastate rates and charges applicable to telecommunications services furnished within the State of California (U 5002 C).	Application 85-11-029 (Filed November 18, 1985)

(See Decision 86-11-079 for appearances.)

INDEX

INDEX

INDEX

O P I N I O N

I. Summary of Decision

This Phase II decision concludes the Commission's review and analysis of AT&T Communications of California's (AT&T-C) audited test year 1986 results of operation.

This decision further reduces AT&T-C's test year 1986 total California operational expenses by $32.4 million ($3.3 million on an intrastate basis), and reduces its total California rate base by $15.51 million ($6.1 million on an intrastate basis) from the Decision (D.) 86-11-079 adopted results. These changes result in an annual gross revenue reduction of $4.4 million on AT&T-C's California intrastate operations. This reduction is spread proportionately to reduce AT&T-C's intrastate long distance (including coin-sent calls) 800, WATS and private line service.

By this order AT&T-C is also directed to make a one-time refund of approximately $109.9 million to its customers for appropriate amounts collected subject to refund pursuant to D.86-11-079 and for flowing through the results of D.87-12-051, D.87-12-067, D.87-12-070, D.87-10-088, and D.88-01-061 concerning access charges, Universal Lifeline Telephone Service tracking and the Tax Reform Act of 1986, which affect the amounts collected by AT&T-C in rates it collected and retained with interest in excess of its allowable expenses.

In D.86-11-079 the Commission held back $15.058 million of AT&T-C's total California operating expenses ($5.754 million on an intrastate basis) pending Phase II hearings on Public Staff Division's[1] audit report. The Commission also made the rates authorized in D.86-11-079 subject to refund.

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1 Since renamed "Division of Ratepayer Advocates (DRA).

Since the receipt and review of the DRA's audit report was the main thrust of Phase II, DRA was placed in a lead posture. However, even though DRA made the initial presentation for all issues in the Phase II hearings, and its position is routinely discussed first in each section of this order, it is clear that the burden of proof for the reasonableness of all expenses rests with AT&T-C under Public Utilities Code (PU Code) Section 454. Therefore, the requirement for a showing of reasonableness of any and all expenses under review herein for Phase II of Application (A.) 85-11-029 still rests fully with AT&T-C.

A. Summary of Recommended and Adopted Phase II Changes in Results of Operations

1. DRA's Position

In Phase II, DRA recommended further disallowances in addition to the amounts the Commission held back in D.86-11-079. DRA's recommendations were vigorously cross-examined by AT&T-C and DRA's final position in Exhibit 243 was changed somewhat from its initial audit report recommendation (Ex. 201).

In Exhibit 243 DRA recommended further expense reductions of $100 million for AT&T-C's total California operations and $29 million on intrastate operations, over and above the amounts [$15.1 million for total California and $5.8 million intrastate operations] held back by D.86-11-079 pending the staff audit.

A detailed breakdown of DRA's recommended Phase II adjustments is set forth in the table which follows AT&T-C's position below.

2. AT&T-C's Position

In Phase II AT&T-C requested that the Commission find its 1986 test year headquarters and other allocated corporate expenses reasonable and appropriate as costs of service for its California customers. AT&T-C then requested an additional $39.7 million allowance for marketing expenses on its total California operations ($18.0 million on an intrastate basis) and the setting aside of the

audit hold-back of $15.1 million ($5.8 million on an intrastate basis) with no adjustments to its intrastate rate base. AT&T-C's request, if approved, would raise AT&T-C's intrastate revenue requirement for test year 1986 by $22.6 million as set forth in the following table.

The figures contained in the "Comparison of Adjustments" and Appendix C tables are rounded to the nearest $100,000 in accordance with the rounding practice used in D.86-11-079. Therefore, it follows that occasionally the dollar amount set forth in the summary tables may be $100,000 higher or lower than the adopted result in any given section of this order.

These rounding changes tend to average out and thus do not alter the significance of any given adjustment, or seriously affect the overall result.

3. Comments: ALJ's Proposed Decision

In accordance with PU Code Section 311 the ALJ draft decision prepared by ALJ George Amaroli was issued on May 11, 1988. Comments on the proposed decision were filed by the following interested parties: AT&T-C, DRA, California Association of Long Distance Telephone Companies (CALTEL), MCI Telecommunications Corporation (MCI), TURN, and U.S. Sprint Communications Company (U.S. Sprint).

These comments have been received and carefully considered by the Commission. Technical changes and corrections of errors necessitated by the comments have been incorporated in this final decision.

Certain portions of the "comments" were simply an extensive reargument of the parties' positions and merely supplemented the arguments previously briefed by AT&T-C and DRA, especially as pertain to marketing, customer service and billing, and the sale of the 195 Broadway property in the AT&T-C comments, and to a lesser extent customer service and billing in the DRA comments. In accordance with the Rules, we have not considered such rearguments in our deliberations.

A new Section XII is included in this final order which covers the matter of overcollections by AT&T-C. This new section considers and incorporates what we believe is the appropriate method of returning certain overcollections accrued by AT&T-C over approximately the last two years. We hereby express our thanks to the commenting parties who all responded to the assigned ALJ's request for comments and expressions of concerns on this subject. We have used the comments and concerns received in the preparation of Section XII of this order.

On June 8, 1988 the assigned ALJ received the "Late-Filed Reply Comments" of AT&T-C, DRA, MCI, U.S. Sprint, and TURN. These late-filed reply comments were carefully reviewed, considered by the Commission, and incorporated where necessary in this decision. Comments received by the ALJ after June 8, 1988 were not available in time for incorporation into this order.

AT&T COMMUNICATIONS OF CALIFORNIA
Comparison of Adjustments
Phase II/A.85-11-029
Test Year 1986
(Thousands of Dollars)

		------ Total California -----			-------- Intrastate --------			----- Rev. Req. Effect -----		
		DRA Exh. 243	AT&T-C* Position	Adopted	DRA Exh. 243	AT&T-C* Position	Adopted	DRA Exh. 243	AT&T-C* Position	Adopted
	OPERATING EXPENSES -									
1	Public Relations	$2,900	$0	$1,700	$1,100	$0	$600	$1,100	$0	$600
2	Reorganization	3,600	0	2,700	1,500	0	1,200	1,400	0	1,100
3	Allocation less Rev.	11,100	0	0	4,700	0	0	4,500	0	0
4	Allocation less Access & Rev.	5,200	0	4,800	2,100	0	1,900	2,000	0	1,800
5	Billing & Collection	79,100	0	46,100	20,100	0	9,100	19,100	0	8,700
6	Corp. Headquaters							4,000	0	2,100
7	AT&T-HQ	7,100	0	4,600	2,800	0	1,800			
8	Gain on 195 Broadway	2,300	0	0	900	0	0			
9	AT&T Tech.	2,700	0	1,000	1,200	0	500	2,100	0	1,300
10	American Transtech	200	0	200	100	0	100	100	0	100
11	R&D & Fund. Research	900	0	900	300	0	300	300	0	300
12	Marketing	0	(39,700)	(14,500)	0	(18,000)	(6,400)	0	(17,100)	(6,100)
13	Subtotals b/4 audit adj.	115,100	(39,700)	47,500	34,800	(18,000)	9,100	34,600	(17,100)	9,900
14	LESS: Audit adj. in D.86-11-079	15,100	15,100	15,100	5,800	5,800	5,800	5,500	5,500	5,500
15	Total Expense Adjustments	100,000	(54,800)	32,400	29,000	(23,800)	3,300			
16	Total Rev. Req. Effect							29,100	(22,600)	4,400
	RATE BASE									
17	AT&T Tech. Calif.	9,500	0	10,300	3,800	0	4,100			
18	Gain on 195 Broadway	5,900	0	5,200	2,300	0	2,000			
19	Total Rate Base Adjustments	15,400	0	15,500	6,100	0	6,100			

* As set forth in AT&T-C's Opening and Closing Briefs.
() Denotes increase in expenses or revenue requirement.

4. Brief Summary of Adopted Adjustments

The following discussion provides a brief statement regarding each of the expense and rate base adjustments listed in the adopted columns of the previous table. A more comprehensive discussion of any given adjustment is contained in the "Discussion" for the section of this decision dealing with that issue and adjustment.

a. Public Relations

This decision reduces DRA's proposed 97.85% disallowance of corporate and field public relations expenses by 41.4%, resulting in an allowance of about 42.7% of such expenses. DRA recommended that we exclude $2.9 million for AT&T-C's total California ($1.1 million intrastate) operations. With the reinstated expense allowance, the adopted adjustments are reduced to $1.7 million for total California and $.6 million for intrastate operations.

The reinstated amounts are intended to cover the noted percentages of the following expenses:

- 25% of "Media Relations"
- 75% of "Employee Communications"
- 50% of "Consumer Affairs"
- 100% of "Policy Briefings"

These public relations functions and activities are found to be necessary on a one-time basis (for one rate case cycle) at or shortly after divestiture as AT&T Corporation's (Parent) (AT&T) overall corporate structure changed to meet its new functional environment and inform its employees, the media, and the general public about its post-divestiture organization, functions, and available utility services.

b. Reorganization

This decision adopts DRA's identified minimum expense savings for AT&T's major corporate reorganization undertaken in 1986. However, since these cost savings were largely associated with AT&T's overall marketing activity, the amount of the expense savings recommended by DRA is proportionately reduced by the ratio of marketing expense adopted herein to the total marketing expense budgeted for the test year.

The resulting adopted reorganization savings are $2.7 million for AT&T-C's total California ($1.2 million intrastate) operations.

c. Allocations Less Revenue

DRA urged that revenues not be used for allocation of marketing expenses and recommended disallowance of $11.1 million in expenses for AT&T-C's total California ($4.7 million intrastate) operations. While DRA's recommendation is sound, it is not being adopted. Since the D.86-11-079 adopted statewide marketing allowance of $104.23 million is being increased by a modest amount to reflect equal access activities which began in 1985 and continued into the test year, as later discussed in this order, it would not be appropriate to reduce it by over 10% by simply applying a different allocations method here, after the fact.

d. Allocation Less Access and Revenues

DRA adjusted the allocation method used by AT&T Communications, Inc., to functionally allocate certain headquarters, corporate, and nationwide expenses to AT&T-C. DRA's allocation method removes access charges from expenses, and deletes revenue and access charges from the composite factor. Access charges were removed on the basis that these charges are merely collected by AT&T-C and passed on to the local exchange telephone companies. The result is a two-factor allocation method rather than the three-factor method used by AT&T, and is too severe for reasonable acceptance.

The three-factor allocation method adopted herein removes access charges from revenues and expenses and substitutes a usage factor in lieu of the revenue factor which is, by coincidence, almost the same as AT&T Communications' 1986 revenue factor recomputed to exclude access charges. The adopted adjustment is a $4.8 million expense reduction for AT&T-C's total California ($1.9 million intrastate) operations, including private line usage.

e. Billing and Collection

This decision directs AT&T-C to set up an interest-bearing memorandum account and place $9.1 million of California intrastate expenses into it, related to the development and deployment of its customer service and billing program which was not fully in place and used and useful during test year 1986. This account will be maintained until AT&T-C's separate billing program is fully operational and used and useful in California.

DRA has recommended the deferral of $79.1 for AT&T-C's total California operations ($20.1 million on an intrastate basis) on the belief that only the account inquiry function was in place and used and useful during the test year.

AT&T-C, on the other hand, suggested, for the sake of argument, a limited deferral of $5.7 million on its intrastate operations until commencement of its direct intrastate toll billing.

This order adopts as reasonable DRA's minimum alternative adjustment of $9.1 million on AT&T-C's intrastate operations as discussed above. This decision also finds that those customer service and billing program functions which were fully implemented, used and useful and not duplicated by the local exchange telephone companies during test year 1986, were developed and deployed in a reasonable and prudent manner by AT&T-C.

f. <u>AT&T-Corporate Headquarters (AT&T-CH)</u>

DRA recommended an adjustment of $7.1 million for investor-related services allocated to AT&T-C's total California operations ($2.8 million intrastate) using a new "equal-to-all" allocations method first adopted in D.86-01-026 issued January 10, 1986 for Pacific Bell's test year 1986 rate case.

However, since we do not adopt DRA's equal-to-all allocations method, the adopted adjustments to AT&T-C's expenses, for corporate and investor-related functions and activities, are reduced to $4.6 million for AT&T-C's total California ($1.8 million intrastate) operations in test year 1986.

g. <u>Gain on Sale of 195 Broadway Building</u>

This decision directs AT&T-C to place $2.0 million in a memorandum account to be credited to its California intrastate rate base representing 75% of the allocated portion of the previously retained (not passed through to ratepayers) gain on sale of AT&T's 195 Broadway, New York headquarters building.

DRA recommended that the allocated gain on sale be expensed over a three-year period at $882,000 per year for AT&T-C's intrastate operations. This order instead adopts a one-time rate base adjustment which has the advantage of being entirely prospective and would essentially have the same effect as it would have had if accomplished in 1983.

h. <u>AT&T Technologies, Inc. (Technologies)</u>

This decision adopts a rate base adjustment of $4.1 million on AT&T-C's California intrastate rate base to be amortized over 11 years, as suggested by AT&T-C, for the remaining predivestiture Western Electric plant adjustment for rate base allocated to AT&T-C at the time of divestiture.

This treatment also includes a $1.0 million adjustment to AT&T-C's total California expenses ($.5 million on an intrastate basis) for test year 1986. This adopted rate base and expense adjustment is based entirely on pre-1984 purchases from Western Electric by The Pacific Telephone and Telegraph Company (PT&T). No new plant adjustments are made for purchases made by AT&T-C in 1984 through 1986 from Technologies since there was no determination of any excessive rate of return enjoyed by Technologies during those years.

DRA had recommended a four-year amortization of the predivestiture plant adjustment which would have resulted in a greater adjustment to AT&T-C's test year 1986 operations, but we find the 11-year amortization consistent with (1) the life of the property involved and (2) the 13-year remaining service life of the comparable property allocated to Pacific Bell in 1984.

This decision also requires modest record-keeping and reporting of AT&T-C's purchases from Technologies together with record-keeping which would allow it to determine the return realized on these intercompany sales, for review in any subsequent AT&T-C rate proceeding or investigation.

i. American Transtech

This decision adopts DRA's recommended total California expense adjustment of $200,000 ($100,000 on an intrastate basis) on the American Transtech allocated expenses to AT&T-C.

This adjustment follows the long-standing Commission practice of allowing affiliated companies the same rate of return for any given year as that authorized for the utility's operations, on the business performed for the utility.

j. Research and Development (R&D) Funding - Bell Labs' R&D

This decision adopts a modest DRA recommended adjustment of $900,000 for AT&T-C's total California ($300,000 intrastate) operations to allow Bell Telephone Laboratories, Inc. (Bell Labs) to earn the same return as was authorized for AT&T-C in test year 1986.

A case could likely have been made to first disallow certain research and development projects as being non-beneficial to the California ratepayers of AT&T-C. While Toward Utility Rate Normalization (TURN) argued for such a disallowance in Phase I, neither TURN nor DRA developed any record in Phase II to support such a disallowance.

This order also sends a strong signal to the parties that a more comprehensive showing of the benefits (or lack thereof) of Bell Labs' research will be expected in future rate proceedings.

k. Marketing

This decision concludes, after extensive review of the record and the arguments presented, that the $104,230,000 allowance for marketing activities adopted in D.86-11-079 for AT&T-C's total California test year 1986 operations, developed from a 1984 base year, was not an adequate amount of overall marketing expenses for a test year which included significant equal access and carrier selection activities. This decision also concludes that 1984 as a start-up year presents too low a base for the test year and that equal access activities in 1985 rendered it as something of a peak year for marketing expenses.

Therefore, this order adopts a compromise of midway between 1984 and 1985 as a marketing expense base for test year 1986. The adopted statewide marketing expense thus became $118.73 million resulting in an intrastate amount of $51.1 million.

B. Summary of Earnings

The adopted summary of earnings for AT&T-C's total California operations and its California intrastate operations is set forth in Appendix C to this order.

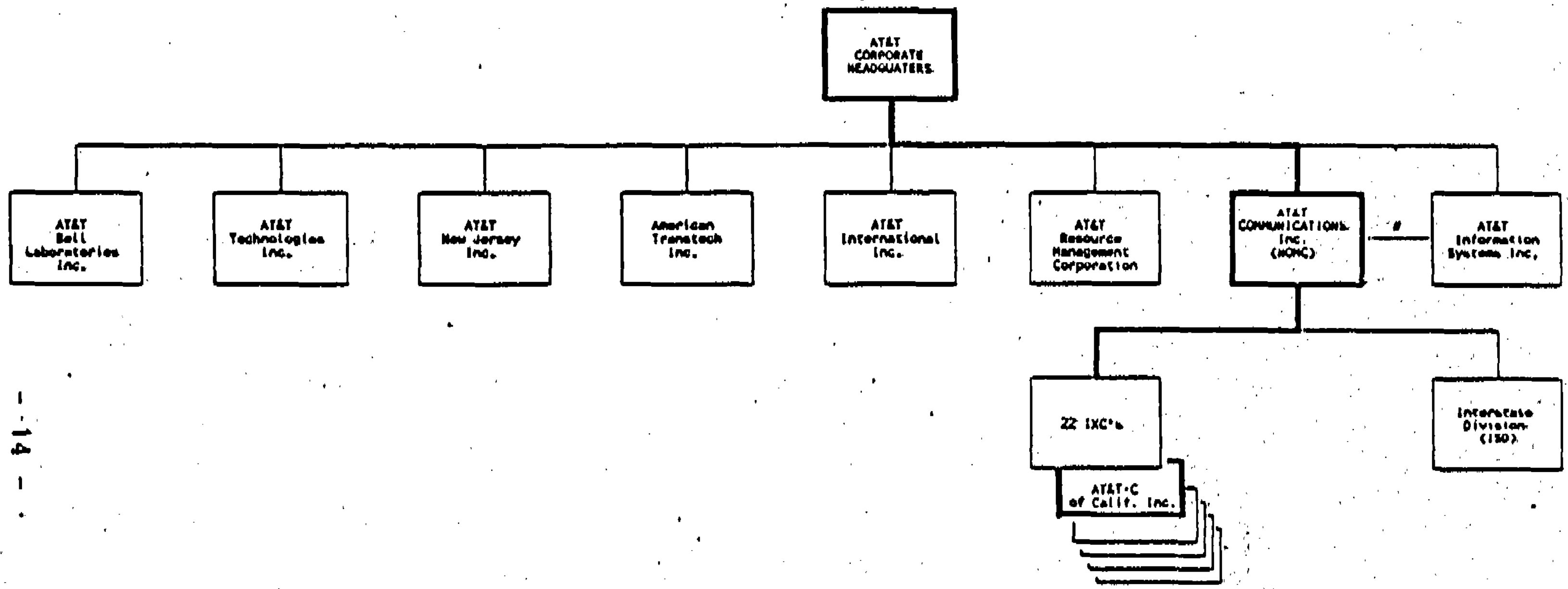
C. <u>Organization of AT&T</u>

To facilitate review and analysis of the various corporate headquarters, general office, and affiliated transactions under scrutiny in this proceeding, a clear understanding of the AT&T Corporation organization structure is crucial. The "AT&T Organization (Legal Structure)" chart, which follows, depicts the test year 1986 organization of AT&T.

The line of corporate control between AT&T-CH and AT&T-C, through AT&T Communications, Inc. (NOMC) which will be described in detail in the various sections of this order, is highlighted on the organization chart. The various affiliated companies and subsidiaries are also shown on the following chart and list of AT&T Communications, Inc. companies.

AT&T Organization (Legal Structure)

Test Year 1986



Notes: Bold lines and boxes depict line of corporate control from
AT&T Corporate Headquaters (AT&T-CH) to AT&T-C (applicant)

AT&T-IS activities are gradually being merged with AT&T Communications, Inc.

Source: Exhibit 201, Appendix II-1, Sheets 2 of 2
and Appendix II-2

22 Interexchange Operating Companies of AT&T Communications, Inc.

1. AT&T Communications of Maryland, Inc.
2. AT&T Communications of Virginia, Inc.
3. AT&T Communications of Washington, D.C., Inc.
4. AT&T Communications of West Virginia, Inc.
5. AT&T Communications of New Jersey, Inc.
6. AT&T Communications of Delaware, Inc.
7. AT&T Communications of Pennsylvania, Inc.
8. AT&T Communications of Illinois, Inc.
9. AT&T Communications of Indiana, Inc.
10. AT&T Communications of Michigan, Inc.
11. AT&T Communications of Ohio, Inc.
12. AT&T Communications of Wisconsin, Inc.
13. AT&T Communications of New England, Inc.
14. AT&T Communications of New York, Inc.
15. AT&T Communications of Mid West, Inc.
16. AT&T Communications of South West, Inc.
17. AT&T Communications of Southern State, Inc.
18. AT&T Communications of The South Central State, Inc.
19. AT&T Communications of The Mountain States, Inc.
20. AT&T Communications of California, Inc. (AT&T-C) (Applicant)
21. AT&T Communications of Nevada, Inc.
22. AT&T Communications of The Pacific Northwest, Inc.

D. Acronyms

Throughout this decision acronyms are used to avoid repeating lengthy names of entities or things frequently discussed. These acronyms are also commonly used by telephone companies and DRA staff in their exhibits and testimony. Each acronym is usually identified initially by its regular (longer) name. A complete glossary of these acronyms is set forth in Appendix B to this order.

II. Background

On November 14, 1986, the Commission issued D.86-11-079 which increased AT&T Communications of California's (AT&T-C) test year 1986 intrastate revenue requirement by $8.391 million and granted AT&T-C a 14.25% return on equity and 12.35% rate of return on its intrastate operations. D.86-11-079 adopted test year 1986 results of operation (R/O) for AT&T-C.

However, D.86-11-079 held a limited number of issues over to a second phase of this proceeding to receive additional evidence on issues raised by a staff audit, which was filed before issuance of D.86-11-079 but after the close of hearings. D.86-11-079 made AT&T-C's rates subject to refund for the specific purpose of reviewing these limited issues. The staff audit was undertaken at the earlier direction of the Commission (D.85-03-056, mimeo. p. 9). The DRA audit was initiated in the fall of 1985; however, due to work on other assignments, and the sheer magnitude of the task of reviewing literally thousands of documents, and interviewing many managers in California, New Jersey, and New York, this audit was not completed until several weeks after the conclusion of the evidentiary hearings on July 3, 1986. Due to the breadth of the audit, responsive information continued to be received right up to the publication of the audit report on July 31, 1986. In that report, the auditors recommended deferred recovery of billing program expenses and proposed ratemaking disallowances for a broad range of other expenses incurred by AT&T Corporation (Parent) (AT&T) directly or through affiliated companies.

Following its review of the audit report, AT&T expressed its concern that numerous errors and misunderstandings were reflected therein. Accordingly, with the express approval of the [then] assigned administrative law judge (ALJ), AT&T met with, and provided additional information to the auditors, in October 1986 and thereafter, in an effort to reconcile factual differences.

When it became apparent that the audit report issues could not be resolved prior to issuance of the interim decision, the Commission deferred the review of DRA's audit to a second phase of this proceeding with hearings to "commence in the summer of 1987" (D.86-11-079, mimeo. p. 26).

On September 25, 1986 AT&T-C filed a "Petition to Set Aside Submission of the Record for the Taking of Limited Additional Evidence" relative to then recent changes in its provision of services and facilities to Pacific Bell under "Shared Network Facilities Arrangements" (SNFA). After considerable discussion the Commission adopted AT&T-C's updated SNFA figures, adjusted to reflect other revenue and expense estimates in D.86-11-079, subject to refund after further hearings in Phase II of this proceeding.

To maintain the status quo established by D.84-06-111 issued June 13, 1984 in A.82-11-07 on issues relative to the Western Electric Adjustment, finance and public relations expenses until the DRA staff audit could be received in Phase II, the Commission held back $15.058 million ($5.754 million on an intrastate basis) from AT&T-C. The Commission also made the rates authorized by D.86-11-079 subject to refund in recognition of DRA auditors' recommendations for other possible adjustments, which otherwise appeared to be settled in Phase I.

Then by D.87-04-041 issued April 8, 1987 the Commission responded to applications for rehearing by AT&T-C and U.S. Sprint, granting limited rehearing on the proper baseline for test year 1986 marketing expenses and correction of calculations for state and federal tax depreciation.

From the historical background discussed above, the following issues for Phase II were established, numerated, and announced as follows at the fourth prehearing conference (PHC) held for this proceeding on April 28, 1987:

1. The DRA staff Audit Report of July 31, 1986 and its March 27, 1987 Supplement,

2. The SNFA issue,

3. The correction of tax depreciation errors; and

4. The appropriateness of using 1985 versus 1984 as the base year for determining AT&T's test year 1986 marketing expense allowance.

Hearings on these issues were then scheduled for the summer of 1987 commencing on July 27, 1987. Twenty-one days of evidentiary hearings were held, 52 exhibits were received in evidence, and the official hearing transcript exceeded 2,150 pages at the conclusion of these Phase II hearings on October 21, 1987. Opening briefs were filed by AT&T-C, DRA, and TURN. Closing briefs were filed by AT&T-C and DRA whereas TURN opted to stand on its opening brief. Phase II was submitted upon receipt of closing briefs on December 31, 1987.

III. Stipulations

Prior to the first day of hearing DRA and AT&T-C reached consensus in two areas: the correction of errors in calculating state and federal tax depreciation, and SNFA. The parties also reached agreement on the appropriate amount of legal advertising expense to be included in corporate advertising.

1. Tax Depreciation Errors

In D.87-04-041 the Commission recognized an error in the calculation of tax depreciation expense and granted AT&T-C limited rehearing to, among other things, correct the amount on the record. While there was some initial confusion about the precise dollar amount in issue, DRA and AT&T-C subsequently stipulated to a $3.012 million figure on April 28, 1987, during the fourth PHC (Tr. 168).

Thereafter, on May 15, 1987, pursuant to the terms of D.87-04-041, AT&T-C filed Advice Letter 83 clearly stating that $3.012 million was the amount of annual revenue being sought; AT&T-C sought permission to recover the change in tax depreciation expense set forth in D.87-04-041, and to reduce its billing surcharge to 0.108%. The Commission by Resolution T-12032 dated June 24, 1987 adopted AT&T-C's Advice Letter 83.

2. Shared Network Facilities Arrangement (SNFA)

In Exhibit 199, Kevin P. Coughlan, DRA's then Project Manager in this proceeding, verified the reasonableness of the updated SNFA information provided by AT&T-C on September 25, 1986, which was incorporated in D.86-11-079.

Coughlan reached this conclusion after review of the workpapers submitted by AT&T-C. He acknowledged that:

> "The financial information provided in those workpapers appears to reflect the activities associated with facilities that AT&T-C leases to Pacific Bell. Another partial confirmation of AT&T-C's estimate is demonstrated by the fact that the revenues received by AT&T-C track with the lease expenses of Pacific Bell" (Ex. 199, p. KPC-1).

Coughlan, under cross-examination, concurred that SNFA effects embedded in AT&T-C's rates should be as authorized in D.86-11-079, with a slight modification to include an additional $0.52 million in AT&T-C's intrastate maintenance expenses set forth on pages 3 and 5 of D.87-04-041 issued April 8, 1987 in this proceeding (Tr. 5267-5268).

3. <u>Legal Advertising Expense</u>

On April 28, 1987 DRA's counsel stated that DRA was ready to agree with AT&T-C that the amount of $0.936 million for legal advertising should be added to the authorized expenses in this case (RT Vol. PHC-4, p. 167). This $0.936 million had been included primarily as part of staff's $3.8 million disallowance for corporate advertising because it was unaudited at the time. After review by the staff auditors DRA now recommends that this amount be added to the authorized expenses. AT&T-C concurs this $0.936 million figure is a total (unseparated) California expense item (RT Vol. PHC-4, p. 168).

IV. <u>Reorganization</u>

As part of its audit, DRA conducted an investigation of the major restructuring, reorganization, employee reductions, and plant consolidations that AT&T announced would take place in 1986. According to AT&T-C this reorganization will continue into 1988 and perhaps beyond. DRA recommended that $3.5 million of the resulting savings be passed on to AT&T-C's total California operations for test year 1986.

1. DRA's Position

DRA's Financial Examiner, Francis Fok, investigated the major reorganization of AT&T and determined that AT&T's staffing reductions actually began as early as 1984 and continued into 1986 (Ex. 201, pp. II-3 and II-4).

DRA contends that AT&T-C has shown no test year cost savings or increased expenses due to these major staff reductions throughout AT&T enterprises. DRA explained in its opening brief that AT&T Communications Companies and AT&T Information Systems (AT&TIS) reduced their forces by significant numbers of employees in 1984 and 1985. DRA went on to say that:

> "In 1985 and 1986, the FCC Computer Inquiry II decision to allow restructuring causes further AT&T staff changes. (FCC Docket 85-26) On January 1, 1986, all ATT-C federal government staff were moved to AT&T-Technologies (AT&T-T). In December, 1985, ten National Account marketing teams from AT&T Communications merged with AT&TIS staff on a trial basis. (Exh. 201, II-6)
>
> "Unrelated to Computer Inquiry II restructuring, numerous employees were transferred from AT&T Communications to AT&T Corporate Headquarters in 1985 and 1986. In September, 1985, 163 tax personnel in AT&T Communication's Central Finance Office were transferred to AT&T Headquarters. On January 1, 1986, the entire Public Relations department (approximately 350 employees), 91 internal auditors, and 150 Medical Department staff of AT&T Communications were transferred to AT&T Corporate Headquarters. In March, 1986, 147 security personnel were also transferred from AT&T-Communications to AT&T Corporate Headquarters. In the same month, 60-70 payroll development personnel were transferred to AT&T-T from AT&T Communications. (Exh. 201, II-6 to 7.)

"Thus, AT&T Communications' workforce was reduced by over 2,600 employees prior to the implementation of the 1986 Reorganization Plan.

"On May 29, 1986, AT&T (parent) announced a major reorganization plan to merge AT&T Communications and AT&TIS into one organization. The plan was scheduled to begin September 1, 1986. (Exh. 201, II-3 to 4) AT&T planned to cut 10,900 (9%) management and 16,500 (8%) non-management employees in 1986. (Vol. 52, p. 6441-2)" (Staff Op. Br., p. 4.)

When asked by staff counsel, AT&T-C's controller, Maud E. Thiebaud, conceded that the main objective for this reorganization and merger was to cut costs to operate even more efficiently (Tr. 6440).

The staff had earlier asked if AT&T had monitored the 1984-1986 changes and evaluated the results and staff argues that AT&T had not done so, even though the joint marketing by the ten National Account teams was earmarked as "trial." Staff also contends that it asked if a reorganization analysis had been prepared before or during reorganization. No such plan was available, according to DRA (Ex. 201, II-7).

DRA argues that, in its petition requesting relief from the Federal Communications Commission (FCC) Computer II Structural Separation order in 1985, AT&T represented that operating costs of $1.1 billion to $1.7 billion could be saved by merging AT&TIS with AT&T Communications and eliminating duplicated resources. Total cost savings of $157 to $327 million were identified in the marketing and marketing facilities categories (Ex. 201, II-7 to 8).

DRA notes that on cross-examination, AT&T-C witness Thiebaud did not deny that the above-stated employee force reductions occurred in 1985 and 1986 (Vol. 51, pp. 6396-6399). Apparently, AT&T-C's estimated 1986 budget was based upon calculations that did not recognize these force count reductions (Vol. 62, 6401-3 and 6414). There was no dispute over whether these employee reductions occurred. The dispute was over the amount of cost savings attributable to AT&T Communications and thereby to AT&T-C in 1986 (DRA Op. Br., p. 5). According to DRA:

> "Since AT&T did not track cost savings or the impact of employee force count reductions, staff used the average savings in marketing and facilities for 1984 which had been estimated by AT&T in its FCC Structural Separation relief petition as a starting point to estimate cost savings. Staff estimated that 50 percent of these savings would go to AT&T Communications and 50% to AT&TIS. Staff added an inflation factor of 5.2% for 1985 and 3.5% for 1986. Staff allocated the amount of savings applicable to California operations for four months in 1986. This equates to a $3.8 million savings to AT&T-C (California) in 1986. (Exh. 201, II-8)" (DRA Op. Br., pp. 5 and 6.)

The $3.8 million savings for AT&T-C's total California operations was revised to $3.6 million in Exhibit 202 and corrected to $3.5 million in Exhibit 246-A.

In response to AT&T-C's rebuttal presentation of cost increases in 1986 due to reorganization, DRA pointed out that lump sum early retirement incentive payments resulting from special programs in 1986 would be amortized over a period, which would be five years under Internal Revenue Code, Section 248 (Vol. 41, p. 5394).

Staff then recommended that the following tracking of future reorganization impacts be ordered, since AT&T-C has no existing (or proposed) procedures:

a. AT&T-C should provide the implementation plan including a schedule of staff changes, whenever this information becomes available;

b. AT&T-C should track all costs associated with the reorganization plan, including employee relocation costs, by organization and type identifying direct and shared costs;

c. AT&T-C should maintain monthly reports on costs tracked;

d. AT&T-C should identify the total effect of these costs in allocations to California;

e. AT&T-C should provide a final report upon completion of reorganization including the total economic impact. (Ex. 201, p. II-11 and DRA Op. Br., p. 6.)

DRA had initially recommended that any decision in this proceeding be subject to subsequently discovered effects of reorganization on the test year. However, staff witness Fok later agreed that rather than issuing another interim decision, it would be preferable to provide the reorganization impact report prior to the submission of the next rate case, similar to the Notice of Intent (NOI) procedure (Vol. 42, p. 5428) (DRA Op. Br., p. 6).

2. <u>AT&T-C's Position</u>

AT&T-C claims that no savings were achieved in the test year (1986) from corporate reorganization and employee reductions. AT&T-C argues that the reorganization adjustment, as proposed by DRA, is for cost savings allegedly realized in the final four months of 1986 as a result of the consolidation between AT&T Communications and AT&TIS authorized by the FCC.

AT&T-C argues that Fok noted that in 1984 AT&T had made a very broad estimate of savings that might ultimately be achieved through the FCC's elimination of the structural separation requirements set forth in its Second Computer Inquiry. While Fok agreed that the estimate used by AT&T in its FCC filing was "a potential range for cost savings" (Tr. 5378), he used that information to speculate that the consolidation of AT&T Communications and AT&TIS would occur effective September 1, 1986, and that AT&T would instantly start realizing all the cost savings predicted in 1984. However, AT&T-C contends that, based on more recent data, no savings were realized in the test year (1986) attributable to corporate reorganization (AT&T-C Op. Br., pp. 73 and 74).

AT&T-C calls attention to Thiebaud's testimony that the actions announced by AT&T in late 1986 involving major restructuring, employee downsizing, and plant consolidations would take place throughout AT&T to refocus business operating strategies to improve competitiveness and profitability by lowering the point at which revenues cover expenses. She further testified that the overall reorganization and force management were not limited to AT&T Communications and AT&TIS, but would in fact affect every AT&T entity and line of business. Additionally, she stated that "these activities are expected to continue through 1988, and perhaps beyond" (Ex. 229, p. 18) (AT&T-C Op. Br., p. 74).

AT&T-C then argues that full-scale consolidation of AT&T Communications and AT&TIS did not occur instantly, as Fok has presumed. Also, the effect of this overall AT&T reorganization was to increase costs in the test year with a very large charge to earnings.

AT&T then summarizes nearly seven pages of DRA witness Fok's cross-examination as concurrence that "AT&T quite probably did not achieve in 1986 the cost savings he had assumed." (AT&T-C Op. Br., p. 75.) AT&T-C urges the Commission to reject DRA's recommended adjustment.

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

DRA in its closing brief argued that at no time did Fok admit that 1986 cost savings would not be achieved. DRA explained that Fok testified that in 1986 alone, 5,000 employees were eliminated, as well as 10,900 management and 16,500 non-management positions. Fok could not distinguish these force reductions as outside of the announced "reorganization" from data submitted by AT&T-C. Fok agreed that cost savings may actually occur in the future; however, total reorganization expenses should be capitalized and amortized over a number of years in order to avoid inequity to current ratepayers paying the expense of employee incentive programs (DRA Cl. Br., p. 10).

4. Discussion

Neither AT&T-C nor DRA provided a complete record of the costs and savings which would result over time from the major ATT corporate reorganization undertaken in 1986. It is clear that DRA was not in a position to do so without extensive information from AT&T; it is equally apparent that this information was not available to DRA, for the purposes of preparing its audit report and the supplement thereto.

In setting rates for any given test year, we attempt to incorporate normalized expenses, so that substantial one time expenses do not unduly distort the revenue requirement. AT&T-C's position of neither asking for additional revenues nor providing information on cost savings to be achieved over time for this reorganization does not assist us in reaching a well-reasoned determination regarding the costs and benefits of this corporate reorganization.

We recognize that the real reason for this reorganization and force reduction is to cut costs and operate even more efficiently as was explained by Thiebaud (Tr. 6440). Without an overall study showing the costs and benefits of this reorganization over time, it is difficult for us to project ahead for the usual three-year rate-effectiveness period following a test year to present worth the future benefits over costs and spread those benefits appropriately over the three-year period.

Since we do not have this comprehensive showing, we will rely on the modest adjustment recommended by DRA ($3.5 million) as a proxy for the minimum savings on an annual basis which AT&T-C will achieve over time from its reorganization and force reduction.

In applying this $3.5 million amount, which DRA has incorporated for the test year, we are aware from DRA's testimony that this force reduction savings is largely associated with AT&T's overall marketing activities.

We have heretofore adopted less than AT&T-C's full Phase I request [of $156,633,000] for the marketing portion of the $200,856,000 marketing and advertising budget.

On this point we concur with AT&T-C that if the overall $3.5 million reorganization adjustment applies to its total California operations in 1986, then it is correct that we should proportionately reduce that adjustment for any adopted disallowance in the overall 1986 marketing budget, where it is accepted that the bulk of the reorganization savings developed by DRA will result. Otherwise, a double disallowance would likely result. Therefore, we will reduce DRA's proposed reorganization adjustment by the following proportion based on our adoption of a marketing allowance of $118,730,000 for test year 1986 adopted elsewhere in this decision.

$$[\ (\$118{,}730{,}000 \div \$156{,}633{,}000) \times \$3{,}500{,}000\ ] = \$2{,}653{,}049$$ [2]

The adopted reorganization adjustment will therefore be $2.7 million on a total California basis using the normal rounding convention. The intrastate portion of this adjustment will accordingly be reduced to $1.2 million.

We will also adopt DRA's recommended record-keeping requirements relative to AT&T's major reorganization. In addition, similar records should be kept for any subsequent reorganizations which have an impact of over $100,000 on the overall operations of

2 Failure to make this calculation would have the effect of adopting a reorganization adjustment of about $5.3 million against AT&T-C's overall marketing budget or a $1.8 million greater adjustment than recommended by DRA.

AT&T-C or result in changes of over $100,000 in allocated costs to AT&T-C's California operations. The $100,000 level for tracking allocated costs or direct expenses to AT&T-C is consistent with the rounding practice used throughout Phases I and II of this proceeding. To require AT&T-C to report with finer detail would constitute an undue burden, and alternatively to require lesser records of AT&T-C's expenses and allocated costs would deny the Commission staff the opportunity for reasonable reviews of the utility's operations consistent with future auditing requirements.

However, we will not require AT&T-C to submit these data until its next general rate proceeding, or in any future investigation into AT&T-C's rates which may be ordered by this Commission.

V. Billing and Collection System

In early 1984 AT&T began developing a multifaceted Customer Service and Billing Program, consisting of eight major business functions, described as follows:

> Account Inquiry--is a computerized data base system that contains an image of the customer records and billing entries for AT&T-C interexchange charges. When the company renders the customer bill, the billing records are provided to the Account Inquiry system. When the LECs render the bill, they provide AT&T-C with a copy of the AT&T-C portion of the bill and it is merged into the Account Inquiry system.
>
> Service Order Entry--is used by AT&T-C to create the records necessary to effect changes to customer accounts.
>
> Message Processing--provides for rating and assembling the usage records that are the basis for customer billing.
>
> Account Maintenance--retains the records of AT&T-C's customers names, addresses and other

> identifiers. This is the central data base for the other computerized systems for accessing information reflecting customer specific data.
>
> Credit and Collection--monitors accounts receivable and notifies AT&T-C representatives when amounts due are in jeopardy of being collected and establishes the extent of credit for customers.
>
> Message Investigation--supports the analysis of unbillable AT&T Communications calls, fraud cases and any errors found during the processing of message records.
>
> Bill Rendering--collects the computer processed data from the other systems, determines the amounts due from the customer, provides details of interexchange calls, applies appropriate taxes, surcharges and other items and prints the AT&T-C customer bill for mailing.
>
> Remittance Processing--creates account receivable update records based upon the amounts paid by AT&T-C's customers. It creates the bank deposits and reconciles the ledger entries for cash and accounts receivable. (Ex. 222, pp. 10-12.)

Some of these functions were in place and were used and useful in California during test year 1986, whereas others were to be phased in for use in subsequent years. The "used and useful" status of these various program functions to California ratepayers in test year 1986 became the subject of intense controversy in this proceeding.

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

DRA, at page 7 of its opening brief, acknowledges that this program was started by AT&T in April 1984 to develop and manage the corporate-wide servicing, management and billing of customer accounts which were performed by the local exchange companies (LEC) at divestiture. DRA then presented its understanding of the implementation schedule for the various program functions which included a 1985 AT&T pilot program in

Minnesota to determine new credit and collection policies, and a 1986 test billing project in West Virginia. DRA stated that interstate private line services have been billed by AT&T Communications since 1984. However, intrastate private line customers were billed by local exchange companies in 1986. Separate billing for interstate WATS/800 was being done in five states, but not in California. DRA Financial Examiner James B. Simmons testified that AT&T-C indicated that none of these activities related to customer billing, other than account inquiry, would be operational in California before 1987. Account inquiry has been performed in California by AT&T-C since 1984. (Exh. 201, VIII-2.)

DRA then recommended that account inquiry costs be allowed, but that the remaining costs of approximately $79.1 million for AT&T-C's total California operations be capitalized due to the magnitude and future benefit of the expenditures. DRA also recommended that interest be earned on the capitalized amount. As portions of the billing system are implemented in California and concurrent charges from LECs are terminated, appropriate costs would be included in rate base and passed on to California ratepayers and other costs would be apportioned to AT&T Information Systems. DRA made no findings regarding the prudency of implementing this billing system. DRA recommended that such a finding be deferred until AT&T-C seeks to place the capitalized costs into rate base (DRA Op. Br., p. 7).

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

TURN argued that AT&T-C has not demonstrated the reasonableness of its billing and collection expenditures, and further review of these billing and collection procedures is appropriate. TURN recommends that this decision affirm the appropriateness of further review of billing and collection issues. TURN also argues that Resolution T-11049 and D.86-11-079 do <u>not</u> constitute approval of the utilities' billing and collection system, nor should they be read to prejudge such a reasonableness review. Both the resolution and the decision clearly were issued to assure prompt recognition of changed circumstances (reduced expenses for billing by Pacific Bell and rate changes for AT&T-C). Neither, argues TURN, contains a finding of fact that AT&T's investments in its new billing and collection system are reasonable, as AT&T-C seems to infer. TURN believes that a prudency review of AT&T's billing and collection system is also appropriate from the standpoint that it will duplicate the services of Pacific Bell and the other LECs.

3. <u>AT&T-C's Position</u>

AT&T-C argues that direct expensing of all development and deployment costs for its customer service and billing system is reasonable.

AT&T-C contends that in permitting joint billing by the Bell Operating Companies of customers subscribing to both their own services and those of AT&T, the Modified Final Judgment presumed that the amount AT&T would be required to pay the Bell Operating Companies for billing services "would presumably be less than that required if AT&T were to provide its own billing." On that presumption, the court declined to require AT&T to develop its own billing capability and permitted continuation of the performance of combined billing services.

During 1983, as the Bell Operating Companies filed proposed access and billing tariffs throughout the nation, it soon became obvious to AT&T that it was not going to receive the anticipated benefits of cost-based pricing for billing services. Rather, the prevailing tendency was to extract profits from their billing services that far exceeded authorized levels of return. AT&T-C determined that the rates adopted in D.83-12-024 for Pacific Bell relative to A.83-06-65 resulted in 186% and 201% return on Pacific Bell's billing services. AT&T-C's witness Connolly testified that it was apparent to AT&T that the LECs had little incentive to restrain the prices they would charge for billing and collection services (Ex. 222, p. 7). Therefore, AT&T undertook a thorough analysis of the alternatives to perpetual reliance on the LECs for billing services. AT&T-C argues that over a six-year study period its own billing system would cost 23% less than the anticipated costs of LEC billing and collection services.

On the question of which customer service and billing functions were used and useful during test year 1986, AT&T-C cited Connolly's testimony:

> "...that <u>all</u> of the systems described earlier in my testimony were functioning in 1986 for California customers, with the billing and message processing operations on line only for interstate services." (Ex. 222, p. 17.)

AT&T-C also contends that:

> "The Company implemented its own billing of interstate WATS and 800 accounts in other states in 1985 and converted its interstate WATS and 800 accounts in California in early 1986. Accordingly, the message processing, credit and collection, bill rendering and remittance processing functions were also used and useful for AT&T customers in California during the test year [for these particular accounts]." (AT&T-C Op. Br., p. 36.)

In late-filed Exhibit 250, AT&T-C summarized its deployment of Customer Service and Billing Program functions in California, as follows:

Function	Service Category	Service Date	California In-Service Date
Account Inquiry	WATS/800	1/84	6/84
	Private Line	1/84	1/84
	MTS	1/84	6/84
Service Order Entry	WATS/800	1/84	1/84
	Private Line	1/84	1/84
	MTS	1/84	9/84
Message Processing	WATS/800	2/85	2/86
	Private Line	N/A	N/A
	MTS	6/87	6/88
Account Maintenance	WATS/800	1/84	1/84
	Private Line	1/84	1/84
	MTS	1/84	9/84
Credit & Collection	WATS/800	2/85	2/86
	Private Line	1/84	1/84
	MTS	9/85	6/88
Message Investigation	WATS/800	1/84	1/84
	Private Line	N/A	N/A
	MTS	1/84	1/84
Bill Rendering	WATS/800	2/85	2/86
	Private Line	1/84	1/84
	MTS	6/87	6/88
Remittance Processing	WATS/800	2/85	2/86
	Private Line	1/84	1/84
	MTS	6/87	6/88

NOTE: MTS stands for Message Telecommunications Service, or toll service. The service is marketed as AT&T Long Distance Service.

AT&T-C then described how California customers were being provided these services from work centers both inside and out of California (Ex. 222, p. 13 and Tab. 3, pp. 31-38).

On expensing versus capitalization of the costs of developing the billing program, AT&T-C's controller Maud E. Thiebaud testified that because of the indeterminant service life of the billing system and its dynamic character, the company's treatment of these costs as current period expenses is required under generally accepted accounting procedures (Ex. 229, p. 4).

AT&T-C's witness Lawrence Gotfried, a partner in the firm of Coopers and Lybrand, concurred with Thiebaud on the expensing of the developmental costs of the billing and collection system.[3]

AT&T-C contends that the record does not support DRA's argument that AT&T-C's provision of customer service and billing functions duplicate those paid to the LECs. AT&T-C refers to Connolly's testimony (at Tr. 6107) that it has discontinued the use of customer service and billing functions from LECs when it deployed its own system to accomplish those functions. Accordingly, AT&T-C claims that neither it nor its customers are doubly charged for performance of customer service and billing activities.

AT&T-C further contends that the two DRA alternatives shown in Exhibit 251 both assume deferred recovery of all intrastate expenses for the organizational units which were performing development work. AT&T-C argues that these activities should be expensed as incurred, and accordingly even the $5.7 million intrastate adjustment would result in an inappropriate deferral of expenses.

AT&T-C concludes that its 1986 test year expenses for customer service and billing functions should be adopted in full. If a limited deferral of recovery of some of AT&T's reasonably incurred expenses is deemed appropriate, it asserts that no more than $5.7 million should be deferred with interest, and the Commission should allow AT&T to recover that amount by a compliance filing immediately upon the commencement of AT&T-C's direct intrastate toll billing (AT&T-C Cl. Br., p. 9).

3 On cross-examination by staff counsel he agreed that it was up to the Commission to decide [whether to expense or capitalize these costs] (Tr. 6217).

4. <u>Discussion</u>

It is clear from the extensive testimony, exhibits, and briefs, that the parties are widely separated in their positions regarding what functions of the customer service and billing system were used and useful to AT&T-C's California ratepayers in the test year (1986). DRA would have us disallow all activities and functions except for the account inquiry function, resulting in a total California operations expense adjustment of $79.1 million and a disallowance of intrastate expenses of $20.1 million.

This position is untenable. When the Commission issued Resolution T-11049 on June 25, 1986 authorizing a reduction of Pacific Bell's charges to AT&T-C in July 1986 for billing and collection services, AT&T-C had either already undertaken, or would soon begin doing, some of the work previously performed for it by Pacific Bell. The resolution even narrated the fact that: "in February 1986, AT&T-C took back its interstate WATS/800 traffic billing" and stated its intention to take back most of its billing functions.

Therefore, at least 30 days prior to the issuance of its July 31, 1986 audit report DRA was, or should have been, aware of reduced activities and charges from Pacific Bell to AT&T-C, with such activities being absorbed by AT&T-C with at least some increases in its own expenses.

On the other hand, AT&T-C's position of having California ratepayers pick up all developmental and ongoing expenses for its customer service and billing functions during test year 1986 is equally insupportable. This position would not be reasonable unless AT&T-C had fully absorbed <u>all</u> program functions including the direct rendering of approximately 10 million customer bills each month. This will involve the stuffing, adding postage, and mailing of these 10 million envelopes to customers each month and then, receiving and processing about 10 million customer payments each month.

On January 13, 1988, the Commission issued an Order Instituting Investigation (I.) 88-01-007 which will investigate AT&T's plan to directly bill its interstate and interLATA business and residence toll telecommunications message services in California on or after June 1988.

This OII is the appropriate forum for determining the reasonableness of AT&T-C's plan and costs to directly bill its customers for interstate and interLATA message toll service. Deferred developmental and other costs, carried forward from this proceeding, should be considered in a future rate proceeding after the AT&T-C take-back occurs. Meanwhile, by deferring a specific amount in an interest-bearing account from the date of this decision as AT&T-C suggests the results of operation for test year 1986 may be finalized and this general rate proceeding concluded.

The specific amount to be deferred is $9.1 million. This is the amount that DRA witness Simmons developed from Exhibit 209, Appendix A, in response to the assigned ALJ's request that DRA give some consideration to the fact that AT&T-C's witnesses Connolly and Thiebaud had testified that certain Customer Service and Billing program elements were in place in California in 1986.

In response to comments by AT&T-C that it would calculate this amount differently and arrive at a much lower deferral, DRA in its June 8, 1988 "Late-Filed Reply Comments" explained that it found no error in its calculation of the $9.1 million deferral, and, "...The 9.1 million [deferral] in billing and collection expenses was calculated using this Commission definition of used and useful facilities."

We will authorize AT&T-C to place $9.1 million of the California intrastate expenses, so allocated from AT&T's development and deployment of its Customer Service and Billing Program, into an interest-bearing memorandum account to accrue interest at the average three-month commercial paper rate as published in the Federal Reserve Bulletin.

This action recognizes that AT&T-C did, according to the record in this proceeding, deploy some portions but not all of its Customer Service and Billing Program for its California operations in test year 1986.

This treatment further recognizes that AT&T did <u>not</u> make a full, timely, and complete showing of which program functions were deployed as used and useful during the test year for its California operations and also recognizes that the major billing and collection function for its residence and business message toll service remained with the LECs during the test year (1986).

Based on the treatment of these expenses there is no need to deal with issues of deferred capitalization or rate-basing the costs for AT&T-C's Customer Service and Billing Program in test year 1986. The unadjusted amounts will be included as test year 1986 operating expenses and the $9.1 million adjusted amount will accrue interest as specified above until further order of the Commission.

This reduced deferral of $9.1 million, contrasted with the $20.1 million disallowance recommended by DRA, recognizes that certain customer service and billing program functions were at least partially implemented, used and useful and not duplicated by the LECs during test year 1986, as previously described. However, we are also persuaded by DRA's May 31, 1988 comments that late-filed Exhibit 250 was not tested and verified and thus cannot be used to determine the prudency of AT&T-C's take-back of its billing and collection service.

The determination of prudency of AT&T-C's take-back of its message billing service from the LECs and its own introduction of direct billing will be determined in a future proceeding.

VI. Corporate Headquarters

AT&T-CH provides the AT&T Communications companies with advice and assistance in public relations, public affairs, legal, planning and financial management, accounting and treasury matters. AT&T-CH's functions also include AT&T's Executive Department and Corporate Secretary.

The decision in Phase I (D.86-11-079) reviewed, in some detail, AT&T-CH's operations and costs. It was AT&T's position that these functions were necessary and cost-effective, since otherwise the AT&T Communications, Inc. [also known as the National Operations and Management Company (NOMC)][4] would have to perform this work and bear the full costs, instead of an allocated portion. As explained in D.86-11-079 expenses for functions performed within AT&T Communications can be defined in three ways:

1. Directly incurred (such as operators' wages or access charges).

2. Directly assigned (such as identifiable expenses which benefit operations in a limited group of states).

3. Functionally allocated (all remaining expenses which benefit all jurisdictions and cannot be directly or uniquely assigned).

Functionally allocated expenses are distributed to jurisdictional entities such as AT&T-C, based upon several factors including average investment, revenues, and composites of several factors.

In Phase I DRA auditors had not completed their review of the corporate headquarters or NOMC expenses. DRA was not satisfied at that time that these expenses primarily benefited California

4 See the Summary of Decision section of this order for further details of AT&T's organizational structure.

ratepayers or the shareholders or individual users of the AT&T products or services. DRA contends that expenses should be allocated to the party who benefits from them, citing prior Commission precedents [(PT&T: License Contract) (1979) in 1 CPUC 2d 488, 574-575; (AT&T-C's 1984 test year proceeding) [D.84-06-111, pp. 97-113 (mimeo.)]. In D.85-03-056, the further opinion on AT&T-C's 1984 revenue requirement, we strongly supported a staff audit of AT&T expressly to allow DRA to determine the reasonableness of expenses being charged to California operations by AT&T-CH and NOMC. In Phase I, of this proceeding, with its audit in progress but not completed, DRA requested that $15.1 million ($5.8 million on an intrastate basis) be withheld from approval until completion of its audit. The basis for DRA's request was set forth in the Phase I testimony of witness Thomas Lew as follows:

> 1. General lack of sufficient detail, audit trail, and/or readily available information to reasonably ascertain what types of projects the national organization has been involved in.
>
> 2. Many data responses have generally been responded to [in] an incomplete manner, notably lacking sufficient detail to be responsive.
>
> 3. Some requested information has not been made available at all.
>
> 4. Completion time for data responses has generally been inordinately lengthy.
>
> 5. Evolving changes in accounting systems has made interyear comparability a very difficult process. (Ex. 100, Appendix 9-A, p. 4.)

DRA's primary concern was with $450.7 million of costs incurred nationally and then allocated or assigned to California from AT&T-CH and NOMC. These, argued DRA, were the same categories of expenses and allocation methods that were in dispute between AT&T-C and staff in 1984. DRA contended that the $5.8 million Phase I hold-back on an intrastate basis simply provided that the 1984 disallowances would be maintained until its audit was complete [D.86-11-079, pp. 52-54 (mimeo.)].

AT&T-C argued in Phase I that DRA's proposed adjustments were nothing more than mechanical continuations of previous 1984 disallowances and that these adjustments are no longer appropriate following divestiture (D.86-11-079, mimeo. p. 54).

With these arguments before us in Phase I of this proceeding we faced two choices: to identify these dollars ($15.1 million or $5.8 million on an intrastate basis), and designate them as a portion of AT&T-C's 1986 revenue requirement, subject to refund at the conclusion of the Phase II proceeding, or to withhold the amount pending completion of the staff audit and hearings thereon. Without the benefit of a completed staff audit we chose the second option and withheld $5.754 million on an intrastate basis until completion of Phase II (D.86-11-079, pp. 57-58 and 2).

The $5.8 million intrastate hold-back of Phase I represented staff adjustments for certain affiliated transactions in addition to the AT&T-CH and NOMC adjustments, which we will now address in this part of the order. The adjustments for affiliated transactions are addressed separately in this order.

1. Position of DRA in Phase II

DRA explains that AT&T-CH bills AT&T Communications (nationwide) (also referred to as NOMC), which in turn bills AT&T-C for certain services. DRA's audit first addressed the basic functional activities performed at the corporate level and made specific recommendations for disallowances of those activities and services that were not considered as benefiting AT&T-C's California ratepayers; DRA then addressed separately the methods used by AT&T-CH and NOMC to allocate the remaining unadjusted expenses to AT&T-C.

DRA further explains that its audit included a review of all AT&T departmental functions as described in Budget Decision Packages (BDP's) and interviews of representatives of each AT&T department. Descriptions of the functions of AT&T's General Departments in 1982 (predivestiture) were compared with 1984 descriptions. DRA contends that it found the holding company functions of these departments in 1986 to be the same as those noted in the last license contract review in 1984.

After this review, staff aggregated the actual expenses into groups of costs with common allocation bases and allocated them as follows:

- o Activities which do not provide any direct benefit to AT&T Communications, which are duplicative of work performed by AT&T Communications, and/or which would not be necessary if AT&T Communications were a stand-alone company. These costs were excluded;
- o Directly assignable costs were allocated to the relevant entities;
- o Activities which exhibited a casual relationship to a measurement base were allocated using that base;
- o Activities which benefited each line of business equally and which required the same amount of time to perform for each entity were allocated equally to all lines of business.
(Ex. 201, IX-4 and staff Op. Br., pp. 17-19.)

DRA states that, historically, this Commission has disallowed investor-related expenses which are primarily incurred for the benefit of a holding company, such as AT&T. (D.90362, D.93367, and D.84-06-111.) DRA auditors reviewed the minor additional functions which have been added since divestiture according to these Commission standards. No disallowances were recommended for preparation of annual reports to stockholders, even though these expenses were disallowed in the past. Prior to divestiture, both PT&T and AT&T issued stock and prepared annual reports to stockholders. Only one expenditure for these dual activities was allowed. AT&T-C, unlike its predecessor, PT&T, does not issue its own stock, and therefore, prepares no stockholder reports. Since there was no longer a duplication of expense, DRA allowed the expense for preparing AT&T's annual stockholder reports. However, DRA recommended reductions in total allocated expenses where the functions of AT&T duplicated those of AT&T-C did not benefit California ratepayers, and were allocated under improper methods. DRA also recommended that different allocation methods be adopted based upon Commission precedents (Ex. 201, p. IX-C-1, Revision III and DRA Op. Br., p. 19).

In its opening brief DRA provided an analysis and recommendation for each AT&T-CH department activity as discussed below:

a. <u>Executive Department</u>

This includes the Office of the Chairman of AT&T and immediate support organizations which provide executive policy and guidance for all AT&T entities. Staff noted that the dissemination of corporate information, previously performed by the Executive Department, had been moved to the Employee Information/Public Relations Department of AT&T.

In previous cases, Executive Department allocations were cut by 61% to remove expenses for investor-related activities. The remaining expenses were allocated as overhead for these same functions.

AT&T Communications has its own Executive Department and Board of Directors. Policy and guidance of AT&T Communications is performed by AT&T Communications personnel. Expenses from AT&T for the same activities are duplicative and are primarily for the benefit of AT&T, the holding company. DRA recommends the same 61%

reduction of these allocated expenses and allocation of remaining expenses as overhead (Ex. 201, IX-6, DRA Op. Br. p. 20).

b. Corporate Secretary

The Corporate Secretary Department includes the office of the Corporate Vice President and Secretary. It provides support to the AT&T Board of Directors, is responsible for shareowner relations programs, and keeps all corporate records. This department performs the same functions as the predivestiture Secretary Department. In the past, this Commission disallowed 100% of these allocated expenses. However, since divestiture, AT&T Communications does not perform these functions, which are primarily required by law. Therefore, DRA recommends no adjustment for these AT&T allocated expenses (Ex. 201, IX-7).

c. Employee Information/Public Relations

DRA claims that this AT&T department provides national advertising, underwrites public television broadcasts, coordinates entity advertising and employee information and communications programs, administers charitable contributions, and maintains corporate archives.

DRA argues that in prior decisions, the Commission disallowed 100% of these expenses on the basis that they were investor-related and primarily aimed at enhancing the corporate image.

In 1986, public relations functions were transferred to AT&T from all of its entities. This involved the transfer of approximately 350 personnel from AT&T Communications alone. It is reasonable, in DRA's view, to expect cost savings due to this consolidation. However, AT&T asserts that this consolidation was designed to increase efficiency and that it is not possible to quantify cost savings (Ex. 201, IX-8).

DRA found that the functions of this department in 1986 were the same as in 1984, with the additional duty of preparing AT&T Annual and Quarterly Reports to shareholders. DRA allowed all of the latter expenses. DRA recommends that 50% of employee information and communications expenses be allowed because there is some general benefit of this service to AT&T Communications' employees. DRA argues that the remaining expenses, which are 97.85%, relate to investor interests and should be disallowed (Tr. 5347 and Ex. 301, IX-10).

d. Public Affairs

DRA explained that this department coordinates governmental matters, including the representation of AT&T enterprises before Congress, state legislatures, the executive branch, and other non-regulatory agencies. The functions in 1986 were the same as 1984.

Traditionally, this Commission does not allow expenses for legislative advocacy, which are deemed to be investor-related. However, expenses for monitoring and disseminating information of legislative activity are allowed.

In 1986, AT&T allocated both legislative advocacy expenses and expenses for monitoring and disseminating legislative information. However, AT&T Communications' External Affairs Department also gathers legislative information and prepares positions on legislation. These expenses duplicate those of AT&T-CH. DRA disallowed 50% of this department's expenses based upon unallowable legislative advocacy and duplication of AT&T Communications' functions (Ex. 201, IX-11 and DRA Op. Br., p. 21).

e. Legal Department

DRA asserts that this department provides periodic legal counsel. It also coordinates all antitrust litigation, although AT&T Communications may perform the staff work. DRA's adjustments were based upon the method of allocation, rather than the appropriateness of total costs allocated.

After aggregating legal expenses, staff allocated some expenses based upon the type of legal activity involved. For example, expenses for legal advice relating to personnel were allocated based on the number of employees. Expenses for legal advice solely related to unregulated entities were excluded. Antitrust expenses were addressed in Phase I of this proceeding. The remaining expenses for ongoing, general legal advice and representation were allocated equally to all lines of businesses (Ex. 201, IX-13 and DRA Op. Br., p. 22).

f. Human Resources, Personnel Management Pension Services, Labor Relations

This department establishes AT&T's personnel policies, coordinates all entities' personnel and labor relations policies, and coordinates bargaining efforts on common issues. In past cases, these expenses were allocated as overhead. DRA allocated these expenses as overhead (Ex. 210, IX-14 and DRA Op. Br., p. 22).

g. Finance Department

This department provides financial management services, including capital acquisition and cash management. Specific activities include financial planning, pension and savings plan management, cash management, banking methods advice, investor relations guidance, and AT&T security financing services. These activities were the same as those performed by the former Treasury Department and Planning and Administration Division of the old General Department. DRA claims that, in previous cases, most of these expenses were disallowed as investor-related activities.

DRA reevaluated the 1986 activities and excluded 100% of the expenses relating to the following activities which do not benefit the California ratepayer:

- Joint ventures, mergers, acquisitions;
- Expenses carried over from the previous year.
- Pool of Funds and Temporary Cash Investments (AT&T surplus cash accounts used for interest-bearing cash advances to all entities);

- AT&T Foundation, a charitable organization;
- Institutional investor relations to maximize the price of AT&T stock.

DRA auditors then identified those functions which should be directly allocated using a specific base. The costs for AT&T's Stock Sale Program and Commercial Paper projects were allocated using capital requirement. The costs of servicing AT&T securities by American Transtech, Inc. were allocated using investment. DRA then allocated the remaining expenses equally to all lines of business on the premise that these functions benefit all entities equally (Ex. 201, IX-15 to 16 and DRA Op. Br., P. 23).

h. Financial Reports, Tax Reporting, Other <u>Chief Financial Officer Functions</u>

This department provides accounting services, coordinates AT&T business plans and budgets, establishes corporate tax policy and prepares consolidated tax returns. Its functions were the same as the predivestiture Comptroller and Planning and Administration Departments. The portion of the comptroller expenses relating to the preparation of Bell System Reports was totally disallowed in prior cases.

DRA asserts that in 1986, 163 tax personnel were transferred to AT&T-CH from AT&T Communications. Tax employees were also transferred from other entities. In 1986, 238 internal auditing and security personnel were transferred from AT&T Communications to AT&T and additional personnel were transferred to AT&T-CH from other entities as well. DRA argues that it would be reasonable to expect that such a large consolidation would result in efficiency gains. However, AT&T showed no cost savings due to this staff consolidation.

DRA excluded expenses unrelated to AT&T Communications, directly allocated expenses solely related to that entity and equally allocated the majority of the remaining expenses (Ex. 201, IX-17 to 18 and DRA Op. Br., pp. 23 and 24).

i. Corporate Strategy and Development

This department provides strategic planning, merger, acquisition and joint venture development, and diversification. This department performs the same functions as the General Planning and Corporate Matters Division of the predivestiture General Department. In previous cases 100% of these expenses were disallowed. DRA recommends the same treatment in 1986 on the basis that it serves only corporate interests, performs investor interest activities, and is entirely duplicative of functions performed at the entity level (Ex. 201, IX-19 and DRA Op. Br., p. 24).

j. Federal Regulation

This department represents AT&T before the FCC. Most of this department's activities relate to the interstate operations, formerly called the "Long Lines Division." DRA explains that it separated these expenses primarily to the interstate jurisdiction (Ex. 201, IX-20 and DRA Op. Br., p. 24).

k. Industry Matters

This department oversees all AT&T entities' efforts in governmental and industry-related actions. DRA contends that this department provides lobbying support and interfaces with the Public Affairs, Public Relations and Federal Regulatory Matters Departments.

In 1985, this department was divided and consolidated with the Public Affairs, Public Relations and Federal Regulatory Matters Departments. AT&T Communications has its own External Affairs Department which analyzes legislation and develops position statements. DRA determined that this department performs a mixture of allowable and disallowable activities and duplicates AT&T Communications' activities; therefore, it recommends a 50% disallowance of these expenses (DRA Op. Br., pp. 24 and 25).

2. Position of AT&T-C

AT&T-C believes that AT&T-CH provides essential home office management functions for AT&T-C and other AT&T affiliated companies. The costs incurred by AT&T-CH are allocated using a composite allocator which includes assets, revenues, expenses, and employee count.

AT&T-C witness Richard B. Troxel, a partner in the firm of Peat, Marwick, Main & Company, testified in Phase I, that these centralized services were beneficial, and not duplicative of functions performed by AT&T Communications. Troxel also contended that the relative number of employees involved in providing home office services was the lowest number of central service employees of all of the companies surveyed as a percentage of sales or overall employees. Troxel opined that AT&T's composite allocations method was reasonable, efficient, and appropriate (AT&T-C Op. Br., pp. 107 and 108).

AT&T-C notes that in Phase II DRA has recommended a ratemaking adjustment to test year AT&T-CH expense of approximately $7.1 million [$9.4 million less $2.3 million for gain on sale of 195 Broadway which is dealt with separately herein] on an AT&T Communications' total California basis (Ex. 201, Ex. 239). The greatest part (approximately two-thirds) of DRA's recommendation is comprised of proposed disallowances in national expenses for functional activities performed at AT&T-CH (Ex. 236, Attachment C, p. 6). AT&T-C contends that the general rationale supporting these proposals is that the Commission made similar disallowances, often in the exact percentage, in predivestiture Bell System License Contract decisions relating to the expense of AT&T's former General Departments. AT&T-C argues that the other portion of DRA's overall proposed adjustment to 1986 AT&T-CH expense is comprised of various reallocations, caused by the subjective use in different circumstances of single-factor allocators, an "equal to all lines of business" allocator, and the redesignation of functional expense as "overhead." Some of these recommendations are based on predivestiture cases; the "equal to all" allocator is based on the limited use of that concept in a recent Pacific Bell case; and other proposals appear to be newly invented (AT&T-C Op. Br., pp. 108-109).

AT&T-C disagrees with what it calls DRA's essentially predivestiture mechanical determinations [disallowances] in this proceeding.

AT&T-C presented the testimony of its Vice President of Regulatory Matters, Robert B. Stechert, and AT&T-CH's District Manager from its Chief Financial Office Department, Conrad J. Ankiel, who contended that post-divestiture circumstances in the test year are different from those prevailing in the Bell System era.

AT&T-C states that, consistent with competitive market conditions and the reduced scale of management activities, AT&T-CH's work force was only about 14% of the size of its predecessor organization after divestiture (Ex. 214 and AT&T-C Op. Br., p. 109).

AT&T-C argues that the Commission should adopt AT&T-CH expenses as reasonable and reject DRA's adjustments which it alleges relied on outdated prior determinations.

AT&T-C also argues that the Commission should reject DRA's attempt to revamp what it believes is AT&T's reasonable and consistent allocation of AT&T-CH expense. It contends that DRA's proposed substitute allocations are inequitable, arbitrary, inconsistent with generally accepted cost accounting standards and not required by prior Commission decisions (AT&T-C Op. Br., p. 109).

3. Discussion of Corporate <u>Headquarters Adjustments</u>

While it is true that the overall organization of AT&T as a corporation has changed significantly as it assumed its post-divestiture structure, and that it has reduced its headquarters staff significantly, it is not true that the specific corporate headquarters functions[5] which were long considered as investor-related have changed sufficiently to be regarded now as directly ratepayer-related.

AT&T witness Ankiel presented a listing and description of corporate headquarters functional activities recommended for disallowance by DRA. Ankiel's descriptions[6] of the DRA disallowed headquarters functional activities confirm that these activities are generally related to non-utility corporate interests or performed for the benefit of investors, rather than AT&T-C's utility ratepayers.

First, with reference to all proposed DRA AT&T-CH disallowances that involve expenditures for any form of corporate advertising, those disallowances were laid to rest with the adoption of the overall advertising budget for AT&T-C in D.86-11-079, and are not being reconsidered here.

Next, on the question of Public Relations and Employee Information activities, AT&T-C has advanced certain arguments which are worthy of our further consideration as to the need, in the test

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5 Before we address a basic review of the DRA staff adjustments for post-divestiture AT&T-CH operations, it is important to note that DRA also proposes a new "equal to all" allocations method which would result in further reduced allocated costs to AT&T-C for allowable corporate headquarters expenses. This new allocations method and the reasonableness of its use for test year 1986 will be addressed later herein.

6 A comprehensive listing of the specific activities identified by Ankiel as being associated with DRA disallowances is set forth in Appendix A to this order.

year, to allow a portion of the overall AT&T Communications (NOMC) public relations expenses. These allowances are not intended to establish new precedents for the future, but do appear to be necessary and reasonable during the test year to help inform employees and consumers, on a consistent basis, of the services which continue to be available from the post-divestiture AT&T-C. This information is considered vital until the public is settled in its selection of an interexchange carrier (IEC) of choice. We will review these necessary test year 1986 public relations functions under the next section of this order dealing with AT&T Communications National Operations and Management Corporation (NOMC).

However, when we address the DRA's recommended disallowances for corporate public relations activities at AT&T-CH as identified by Ankiel, we again see the types of public relations functions and activities which we have long regarded as investor-related. Perhaps, the clearest examples, apart from the advertising examples, are exhibits for special corporate events, underwriting "The MacNeil/Lehrer NewsHour" and the sponsorship of a quality arts program.

For example, AT&T contributed nearly $4.8 million, on a nationwide basis, for the underwriting of "The MacNeil/Lehrer NewsHour," program in 1986 (Ex. 236, Attachment C, Sheet 3 of 6).

It is quite proper for a Public Broadcast viewer to voluntarily contribute to support the Public Television Station that airs this program. However, it is an entirely different matter to ask that the AT&T-C customer contribute to the development and airing of that program, on an involuntary basis, through his/her interLATA telephone bill. The same is true of the other DRA recommended adjustments for corporate public relations activities and functions which include a wide range of cultural, education, charitable and corporate identity programs. Therefore, we will generally adopt DRA's position on AT&T-CH's public relations activities disallowance, except as discussed further under the AT&T Communications (NOMC) section of this order.

A review of Ankiel's AT&T-CH legal activity descriptions reveals that these DRA disallowed services are clearly investor-related, dealing with acquisitions, mergers, and/or joint ventures. DRA did not exclude legal services for ongoing, general legal advice and representation as discussed earlier. We will adopt DRA's partial adjustment of AT&T-CH's legal department activities for investor-related functions.

The portion of AT&T-CH's corporate finance and accounting functions, which deals with temporary investments, strategic and operational tax planning, AT&T data systems activities, financial analysis, AT&T consolidated business planning, investor and financial community contacts, internal audits, joint venture/merger acquisition activities, corporate financing, and administration of AT&T Foundation, recommended for disallowance by DRA, as described by Ankiel, is again clearly investor-related. Therefore, we will adopt DRA's partial adjustment for the investor-related portions of these Financing and Accounting functions.

Lastly, Ankiel's description of AT&T-CH's Corporate Strategy and Development functional activities underscores DRA's point that the activities serve corporate interests only. We have routinely disallowed 100% of the expenses for these activities in the past, as being exclusively corporate and investor interest-related. We will again adopt these same adjustments.

DRA has recommended an adjustment of $7.1 million for AT&T-CH's overall services allocated to total California operations, which would result in a disallowance of $2.8 million on AT&T-C's California intrastate operations. However, since we are not adopting DRA's equal-to-all allocations method for test year 1986, as will be discussed next, the adopted adjustments to AT&T-C's expenses allocated to AT&T-C are reduced to $4.6 million for its total California operations and $1.8 million for its intrastate operations for test year 1986.

4. DRA's New Equal-to-All Allocations Method

In this proceeding, in addition to performing the long-standing adjustments for investor and holding company functions and activities, DRA has proposed that we allocate certain of the remaining allowable expenses on an equal-to-all lines of business basis, to which AT&T-C strenuously objects. DRA applied this new allocation method to the adjusted (allowable) expenses of the following corporate headquarters departments:

- o Legal
- o Finance
- o Financial Reports, Tax Reporting, and Chief Financial Officer

DRA believes that it is proper to use this new method of allocating corporate expenses wherever the benefit of a given service appears to be of equal value to all lines of business, and the expenses are not otherwise directly assignable. An example of an expense which would best fit this description is the preparation of AT&T's Corporate Consolidated Federal Income Tax return by assembling the contents of all of the "Separate Federal Income Tax" returns of the affiliated and subsidiary companies. The work of combining these "Separate" returns into a "Consolidated" return appears to be of equal value to all affiliated and subsidiary companies. Therefore, DRA's proposed "equal-to-all" allocations method would be reasonable and proper for this and similar home office expenses, that benefit all lines of business equally.

Unfortunately, its application and adoption in this proceeding would not be consistent on a rate-fixing basis with the allocations methods utilized by other state regulatory commissions or the FCC. We have heretofore adopted DRA's new equal-to-all lines of business allocation method in D.86-01-026 issued January 10, 1986 for Pacific Bell's test year 1986 rate proceeding (Finding 14, mimeo. p. 207).

However, Pacific Bell's utility telephone service is, for the most part, provided wholly within California and on a local exchange and intraLATA basis is subject to the regulatory authority of this Commission.

Therefore, while DRA's equal-to-all lines of business allocation method has great merit, we will not adopt this allocation method for determination of AT&T-C's 1986 results of operation.

We will, however, encourage AT&T-C to consider the future use of this method, where other direct allocations methods are not possible and where equal benefit to all lines of business exists. In so doing, we will also place AT&T-C on notice that there will be a further opportunity for DRA again to present evidence and arguments for the adoption of this allocation method in any future AT&T-C general rate proceeding or rate investigation.

We also encourage DRA to further advance discussions regarding the use of this allocation method in its regular conferences on utility accounting practices involving other regulatory agencies throughout the nation, and through its membership on the National Association of Regulatory Utility Commissioners (NARUC) Staff Subcommittee on Accounts.

5. DRA's Recommended Use of Account 674 for Corporate Headquarters Expenses

DRA has recommended that AT&T book all corporate expenses to AT&T-C in Account 674, General Services and Licenses, for purposes of consistent reporting on a Uniform System of Accounts (USOA) basis. DRA cited a precedent for this in D.86-01-026 for Pacific Bell (DRA Op. Br., p. 25).

AT&T-C contends, as explained by its Controller Maud E. Thiebaud, that AT&T discontinued the use of Account 674 at divestiture, and that account is not being used for reporting to any regulatory commission. To reinstate Account 674 would be extremely burdensome (AT&T-C Cl. Br., p. 23).

AT&T-C argues that disposition of the Account 674 issue be left in I.87-02-023 relative to revision of the USOA for telephone companies, and not be separately considered in this proceeding. AT&T-C also called attention to DRA witness Simmons' concurrence that a decision regarding Account 674 should be consistent with the final determination in I.87-02-023 (AT&T-C Cl. Br., p. 23 and Tr. 5707).

By D.87-12-063 issued December 22, 1987 the Commission generally adopted the requirement for the use of Account 674 for affiliate company transactions, but exempted AT&T-C from such a specific requirement with the following proviso:

> "g. AT&T shall maintain its data on affiliate company costs on a side record basis and shall not be required to set up a separate and unique subaccount code to record these costs." (D.87-12-063, mimeo. p. 48.)

Since D.87-12-063 has addressed and resolved the Account 674 issue, we will not revisit this matter here, except to use the determination reached in that order for the purpose of future reporting requirements set forth in this order.

VII. National Operations and Management Corporation (NOMC)

AT&T Communications, Inc. operating on a nationwide basis is known as NOMC and manages 22 IECs including AT&T-C's California operations. In addition, NOMC manages AT&T's Interstate Division. NOMC performs support, operational planning, public relations, and management functions on behalf of AT&T Communications, Inc. In addition, NOMC passes through the costs of AT&T-Corporate Headquarters (AT&T-CH) to the 22 AT&T Communications' operating companies, including AT&T-C and its Interstate Division.[7] NOMC thus provides many of the typical general office functions for the 22 IECs that serve as part of AT&T Communications' nationwide operations.

A. Specific DRA Recommended <u>NOMC Expense Adjustments</u>

NOMC has been separately reviewed by DRA auditors because the expenses for its services are allocated differently than those of corporate headquarters AT&T-CH.

1. <u>DRA's Position on NOMC</u>

DRA in its July 31, 1986 Audit Report explained that about 1/6 of AT&T-NOMC expenses were directly assigned and 5/6 were functionally allocated. DRA auditors focused on the functionally allocated NOMC expenses for their further review and proposed adjustments (Ex. 201, p. V-1).

DRA auditors provided a breakdown of NOMC's estimated functionally allocated expenses for test year 1986 as follows:

7 See the "Summary of Decision" section of this order for more details of AT&T's organizational structure.

Department Source	NOMC's Estimated 1986 Functionally Allocated Expenses Total	Calif. (000's)	Intrastate
Customer Service & Billing	$ 549,420	$ 49,228	$ 13,730
Ext. Affairs-Regulatory	11,503	972	372
Ext. Affairs-Industry Affairs	38,890	3,470	1,436
Ext. Affairs-Public Relations	34,925	2,954	1,127
Finance	620,388	52,067	14,223
Legal	46,422	3,927	1,491
Marketing	1,960,410	179,097	75,768
Network	730,870	56,101	21,875
Personnel	114,045	8,745	3,348
Pensions, Benefits, PR Taxes	77,946	5,825	2,298
AT&T Corp Hdqrts.	291,288	25,116	9,829
Total	$4,476,107	$387,502	$145,497

(Ex. 201, p. V-2.)

DRA's audit team stated that it attempted to narrow the source of NOMC's estimated functional expenses by identifying the activities and projects that would support the recorded dollars for 1984 and 1985. However, according to DRA auditors, the company representatives repeatedly stated that they neither budget nor keep their books and records on such a basis. DRA auditors then explained that as an alternative (to a standard audit of the booked figures) they attempted to gain as thorough an understanding of each NOMC department as possible through meetings with departmental representatives and reviews of examples of departmental outputs. Since most of the functionally allocated costs are generated out of AT&T-C's corporate headquarters in New Jersey, the team states that it conducted part of its investigation there, during the months of May and June 1986. DRA auditors then took the information acquired through these interviews and inquiries, and substantiated the data and statements by sampling departmental outputs. The auditors contend that the use of the more traditional record sampling and detailed audit techniques would have required much more time than was available to them (Ex. 201, pp. V-2 and V-3).

In Chapter V of Exhibit 201, the DRA auditors separately discussed their audits of the External Affairs (regulatory, industry affairs, public relations) Finance, Legal, Personnel and the Operator Services functions' expenses allocated by NOMC. Of the NOMC's estimated expenses allocated to California, in test year 1986, nearly 62% involved customer service and billing, and marketing functions. These expenses and DRA's recommendation, including issues dealing with allocations from NOMC to California, are dealt with in separate sections of this order.

The DRA audit team, while dissatisfied with the lack of project tracking and activity record-keeping, did not make recommendations for significant test year 1986 disallowances for the Finance, Legal, and Personnel functions of NOMC or the Operator Services allocated to NOMC's Network function from AT&T-CH (Ex. 201, pp. V-6 - V-8).

DRA did however recommend that NOMC's estimated test year public relations expenses be reduced for ratemaking purposes by a factor of 97.85% of the budgeted amount. This is the same level of disallowance as recommended by DRA for AT&T-CH's Public Relations Department expenses in the test year.

On the issue of NOMC's External Affairs Department (public relations) activities, DRA Financial Examiner, Tom Doub, contended that the Commission has long regarded activities involving the influencing of public officials or public opinion, or institutional image building as not appropriate for ratepayer funding. He opined, on behalf of the audit team, that this policy is still appropriate because the company is still essentially a regulated utility that enjoys 80%+ of the market, and because proper cost allocation would dictate that these costs belong to investor-related expenses.

Doub then explained that prior to January 1, 1986 public relations was included in the External Affairs budget. The public relations functions were subsequently transferred to AT&T-CH. The budget for these activities (approximately $35 million and 350 people) is expected to remain the same in External Affairs, since the same costs are expected to be billed back from AT&T-CH.

Doub further explained that the amount estimated under the public relations category for 1986 was $34.9 million for AT&T Communications total functionally allocated costs, and $3.0 million for total company California operations of AT&T-C. Since the activities and dollars affecting AT&T-C were expected to be the same during 1986, the audit team felt that it was appropriate to reduce 1986's estimated expenses, for ratemaking purposes, by 97.85% of the budgeted expense, the same proportion that it used for the corporate headquarters public relations expense adjustment. The adjustment amounts to $34.2 million for total AT&T Communications, and $2.9 million for the California operations of AT&T-C (Ex. 201, p. V-4).

DRA made no adjustments for estimated NOMC regulatory or industry affairs expenses in test year 1986, for Phase II of this proceeding.

2. Position of AT&T-C

AT&T-C contends that AT&T's field public relations expense was treated in summary fashion in Chapter V of the audit report. Relying wholly upon the separate conclusions of the auditor reviewing AT&T-CH's activities, DRA witness Doub urged a 98% disallowance of field public relations expense (AT&T-C Op. Br., p. 80).

AT&T-C argues that:

> "in attempting to justify this extreme recommendation, Mr. Doub indicated that he had assumed, based on a corporate reorganization for 1986 consolidating all public relations employees into AT&T Corporate Headquarters, that field public relations activities would be the same as those of AT&T Corporate Headquarters (Tr. 5350-51)." (AT&T-C Op. Br., p. 80.)

Kenneth P. Todd, AT&T's Division Manager-Public Relations, testified that locally budgeted field public relations functions were unchanged by this organizational change, which was entirely administrative in nature (Ext. 237, p. 6; Tr. 6687-89, 6696). Further, Todd distinguished the limited, centralized work performed by AT&T-CH (described by the functional activity descriptor documents reviewed by the auditors) as generally separate from the work performed by field public relations personnel (Ex. 237, p. 5; Tr. 6687, 6691-92). Moreover, Todd claimed that AT&T's rate case data request responses and workpapers have consistently shown that the field public relations groups and the AT&T-CH's groups are separate budgeting entities performing separate functions (Ex. 237, pp. 6 and 7).

AT&T-C argues that under these circumstances, it was unreasonable for the auditors to make such a facile and mechanical disallowance recommendation to AT&T's field public relations work - even if it were assumed that the proposed AT&T-CH's disallowance were appropriate.

AT&T stresses Todd's testimony that:

> "[T]he audit Team has chosen to ignore a substantial amount of information the Company provided which describes the various activities of the San Francisco-based AT&T Public Relations group under my supervision, and that of other similar field Public Relations groups. There is little or no recognition of the many important Public Relations activities conducted locally in California to inform Californians about how to use the telecommunications services available to them from AT&T. These field public relations activities represent the bulk of the expenses allocated to AT&T Communications of California which I explained in my original testimony, Exhibit 73 (Ex. 237, p. 5)."

AT&T further argues that:

> "The auditors' mechanical application to field public relations activities of a 98%

> disallowance factor is particularly inappropriate for the one public relations activity analyzed in the Audit Report -- employee communications. The first obvious flaw in this approach is its unfair effect on the calculation of a proposed disallowance. At Chapter IX, in a discussion of AT&T Corporate Headquarters activities, the auditors indicate an intent to disallow 50% of this function. (Ex. 201, p. IX-9). Based on the relative mix of AT&T Corporate Headquarters public relations expense, this equates to a 2% allowance of all AT&T Corporate Headquarters public relations activities; yet, a 50% allowance of field employee communications activities would amount to far more than 2% of all field public relations expense." (AT&T-C Op. Br., p. 82.)

Todd further testified that the purpose of AT&T's employee information activities is not to sell stock to employees, because the ESOP (Employee Stock Ownership Plan) to which DRA auditors alluded, is wholly funded by the company. Todd had also testified that:

> "The purpose of AT&T's Employee Information activities is to disseminate timely and accurate information about the company and the telecommunications industry to all AT&T employees. This responsibility is carried out through the publication of bi-weekly regional newspapers, weekly bulletins, a bi-weekly newsletter for Regional employees and videotape programs. Topics covered in the articles and features in these publications include new AT&T Communications service offerings, new technology, significant sales, improvement in the quality of work life and cost-saving measures effected by employees. These publications keep employees up-to-date and well-versed on current issues affecting the public, such as the carrier selection process, the changes in the way customers dial the operator, new service offerings and proposals being considered by state and federal regulators affecting the industry.
>
> "Employee publications are also effective in reporting on the contributions of fellow

employees in all departments for the benefit of those who, in carrying out their day-to-day jobs, would likely not be aware of events outside their departments. This enhances employee morale and productivity." (Ex. 237, pp. 7-9 and AT&T Op. Br., p. 83.)

AT&T then renewed Todd's claim that the [DRA] auditors had not identified a single article in a single employee publication that supports their erroneous conclusion of "primarily image enhancement activities." (Ex. 237, p. 9 and AT&T-C Op. Br., p. 84.)

AT&T concluded its argument by claiming that it has fully justified its field public relations expenses. It believes the 98% disallowance factor which DRA would mechanically apply to these useful and beneficial activities is wholly unjustified and in disregard of the record evidence. According to Todd:

> "The California public, which is also AT&T's customer body, needs to know as much as possible about available telecommunications services in order to make informed choices and, therefore, get the most value for the prices it pays for the services. Employees can do a better job for the public they serve if they know what is available and how it is provided. Disallowing the expenses for these processes would leave an uniformed public and employee body, if the Company had to curtail its Public Relations activities. Surely this result would not be in the public interest." (Ex. 237, p. 12.)

AT&T contended that it has provided on the record full, factual, and specific descriptions of its field public relations activities and their benefits to California ratepayers. Finally, AT&T-C called attention to this Commission's recognition of its improved showing in Phase I of this case compared to the 1983-84 rate proceeding where it received a 100% disallowance of similar public relations expenses. However, AT&T-C states that we withheld granting it any recovery of public relations expenses until the

Phase II record was fully developed on this issue. Now that the record is complete, AT&T-C asks that its public relations expenses be granted in full.

3. Discussion

In Phase I DRA and TURN both opposed any allowance for corporate or field public relations expenses for AT&T-C. TURN contended that much of AT&T-C's public relations effort was corporate overkill and that many of the functions performed by the public relations group duplicated those of the marketing group.

AT&T-C supported its Phase I request for $3.601 million of public relations expenses on total California operations and $1.372 million on an intrastate basis by arguing that these activities provide clear and important benefits to California ratepayers (D.86-11-079, mimeo. p. 91).

AT&T-C also argued that the 100% disallowance adopted by the Commission by D.84-06-111 in 1984 was inapplicable in this proceeding, because the prior disallowance was premised on the lack of explanation or supporting documentation for AT&T-C's request. AT&T-C also opined that if it had presented a full showing for the 1984 decision, public staff would not have recommended any disallowance. AT&T-C in Phase I also cited the decision in the Pacific Bell rate case (D.86-01-026) which allowed 75% of Pacific Bell's requirement for public relations. Based on what AT&T-C termed a sparse showing in that proceeding, the Commission concluded that by its very nature some portion of this expense enhanced the corporate image of Pacific Bell, which is an activity which does not materially benefit ratepayers (D.86-01-026, p. 170). AT&T argued that if, on such a meager record, the Commission allowed most of Pacific Bell's request, surely AT&T-C is entitled to a full award, given the far greater evidentiary detail it has presented (D.86-11-079, mimeo. p. 92).

In D.86-11-079 we stated that "we are inclined to agree that AT&T-C has provided a much improved showing in test year 1986, but our 1984 disallowance was premised on following prior precedents and lack of demonstration of clear benefits to ratepayers." (D.86-11-079, mimeo. p. 93.) We then left the record open to receive DRA's audit report and deferred the issue until the record was fully developed in Phase II.

In Phase II DRA would disallow 97.85% of AT&T-C's California intrastate public relations expenses as allocated from AT&T-CH and NOMC. DRA's recommended disallowance is $1.1 million on an intrastate basis (Ex. 243). DRA used the same 97.85% disallowance factor for AT&T-CH and NOMC.

This Commission has consistently disallowed[8] the majority of all utility public relations activities because these activities generally were viewed as providing greater benefits to shareholders than to ratepayers, and more importantly were not found to be necessary in the provision of a monopoly utility service. However, AT&T-C comes before us with a request to allow such expenses in a test year two years after divestiture and at a time when its customers and potential customers were making IEC selections as part of equal access balloting. AT&T-C raises many supportive arguments for allowing some, if not all, of its public relations expenses.

DRA recommends against significant allowances for public relations activities and functions that primarily benefit corporate image or AT&T's investors.

Both arguments are sound; however, neither DRA or AT&T-C has prepared or presented a logical or rational middle ground for allowing those public relations expenses that were necessary at, or shortly after, the time of divestiture to respond to the following needs:

8 The one exception being D.86-01-026 for Pacific Bell where a 75% allowance of public relations expenses was granted.

- o Timely, accurate, and consistent information to customers and prospective customers of utility services from AT&T-C regarding available services, rates, and optional rates available from AT&T-C.

- o Timely, accurate, and consistent information in response to media inquiries regarding the utility services available from the post-divestiture AT&T Communications companies.

- o Timely, accurate, and consistent information to AT&T-C employees concerning corporate functions, work requirements, redirections, and reorganizations which were necessitated by the divestiture.

These were important one-time public relations requirements which appear necessary both for the benefit of ratepayers and shareholders at and shortly after divestiture as AT&T's overall corporate structure changed to meet its new functional environment.

By providing timely, accurate, and consistent information to the media and the public about its post-divestiture utility services, AT&T-C was able to retain about 82% of the interexchange market. This strength and dominance helps assure reliable service to the most remote rural areas and the ability to meet any growth in demand for new service.

By providing timely, accurate, and consistent information about corporate changes in functions, direction, and reorganization after divestiture, AT&T-C was very likely able to also maintain employee morale at a favorable level to meet its new commitments in the post-divestiture environment.

We should balance ratepayer and investor interests to cover expenses for these three important public relations functions for one rate case cycle.

Since we do not have actual cost data for these functions, we will rely on Todd's tabulation from his Phase I testimony [Exhibit 73, page 5] where the major 1986 Public Relations functions, and the proportion of the total Western Region Public Relations budget they represent were broken out as follows:

		Approx. $*
o Media Relations	31 %	$341,000
o Employee Communications	27.2%	299,200
o Community Relations	5 %	55,000
o Consumer Affairs	24.5%	269,500
o Executive Communications Support	3 %	33,000
o Research and Planning	5.7%	62,700
o Policy Briefings	1 %	11,000
o Administrative/Other	2.6%	28,600

*Calculated amount of allocation to AT&T-C's California intrastate operations for given percentages of budget.

Being mindful to address only those areas where ratepayer interests are evident and sharing those functional costs with AT&T's shareholders, we will allow the following percentages of the functions named and previously described, as follows:

- 25% of Media Relations expenses to account for timely, accurate, and consistent responses to media inquiries only. This assumes that media inquiries constituted approximately 25% of Media Relations effort, for an intrastate allowance of $341,000 x 25% = $85,250.

- 75% of Employee Communications expenses to assure that employees are fully aware of AT&T and AT&T-C's post-divestiture operational functions requirements and goals, and that employees can effectively communicate the nature and availability of AT&T services accurately and consistently with customers on a timely basis. 25% of these Employee Communications expenses are left for the investors to share since effective employee performance is to their benefit as well. This also accounts for any stock performance and other investor information commonly shared by public relations personnel with employees. This results in an intrastate allowance of $299,200 x 75% = $224,400.

- 50% of Consumer Affairs expenses for timely, accurate, and consistent responses to customer and public inquiries as contrasted with AT&T-C's initiated marketing or customer contact functions. This assumes that customer inquiries account for about 50% of Consumer Affairs expenses, for an intrastate allowance of $269,500 x 50% = $134,750.

- 100% of the cost of policy briefings even though there may well be significant investor-related benefits resulting from these policy briefings, resulting in an intrastate allowance of $11,000.

The recap of these reinstated expense allowances is as follows:

o Media Relations	31 % x 25% =	7.75% =	$ 85,250
o Employee Communications	27.2% x 75% =	20.40%	224,400
o Consumer Affairs	24.5% x 50% =	12.25%	134,750
o Policy Briefings	1 % x 100% =	1.00%	11,000
Total		41.40%	$455,400

This 41.4% allowance will be applied to reduce DRA's 97.85% public relations expense disallowance of 1.1 million by $455,400 resulting in a public relations expense disallowance of $644,600 ($.6 million rounded) allocated to AT&T-C's California intrastate operations. On a total California operations basis, DRA's public relations adjustment of $2.9 million for AT&T-C would be reduced to $1.7 million.

B. Excluding Access Charges
for Allocations

In allocating NOMC expenses to AT&T-C, NOMC included access charges as part of its bases for revenues and expenses. DRA auditors removed both revenues and access charges from the bases used for allocating NOMC expenses to AT&T-C's California operations.

1. Position of DRA on NOMC Allocations

DRA auditors claim that NOMC allocated about 31% of its expenses to AT&T-C using a composite three-factor method which averaged revenues, expenses, and investment. DRA auditors contend that access charges should not be part of the revenue or expense components because access charges are merely amounts collected from the ratepayer on behalf of the LEC. DRA auditors claim that AT&T-CH personnel agree with DRA's view regarding access charges (Ex. 201, pp. VII-1 and VII-5). The DRA auditors adjusted the NOMC allocated expenses, by altering the allocations through removal of revenues and access charges (Ex. 10, p. VII-6). This resulted in a reduction of NOMC charges to AT&T-C's total California operations of $5.2 million and $2.1 million on California intrastate expenses (Ex. 243).

2. Position of AT&T-C on NOMC Allocations

AT&T-C at page 86 of its opening brief describes a four-factor Composite B allocation method which was used by AT&T-CH for allocation of its Finance, External Affairs, and Legal Department expenses. This "Composite B" allocation method uses expenses, revenues, assets, and employees to form a weighted average "Composite B" allocation factor.[9]

9 We are not aware of any DRA issue with this AT&T-CH four-factor method, because no access charges are included in the revenues or expenses for this method.

Next, AT&T observes that:

> "The auditors have recommended disallowance of approximately $2.1 million (intrastate) to these various departmental costs to reflect removal of access expense and an equal amount of revenue from the allocation process. (Ex. 201, p. VII-6; Ex. 206). The alleged bases for this proposal are that AT&T Corporate Headquarters nets access charges against revenues in AT&T consolidated financial statements, that much of AT&T's revenue is intended to recover access costs, and that different commissions may set access expense differently."

AT&T-C then argues that while all of these observations may be true, they do not warrant any adjustment, and AT&T's existing composite allocation methodology should be retained as reasonable and appropriate (AT&T Op. Br., p. 86).

AT&T-C witness Thiebaud explained that access charges are the most significant expense for any AT&T Communications company. For example, in D.86-11-079, access charges were approximately 69% of the total adopted costs of service (Ex. 229, pp. 14-15). Because of this impact, access expense, or a corresponding amount of revenue, may be excluded from total results for the purposes of consolidated financial statements issued by AT&T-CH. This is done merely to allow for comparability of AT&T Communications with other AT&T entities (Tr. 6387).

AT&T-C's Troxel, its witness on allocations, observed that, "what AT&T Corporate Headquarters does for its financial statements is fundamentally irrelevant to the allocation among AT&T Communications companies of nationwide AT&T Communications costs." (Ex. 235, p. 7.)

AT&T-C further argued that finding a flaw with recovering access charges in revenues can be compared with an argument for exclusion of depreciation, or other components in rate base. AT&T-C also contended that it is of no consequence that the various regulatory commissions have established different rates for access charges, or that some commissions have imposed a subscriber line charge to recover non-traffic sensitive access costs, while others have not (AT&T-C Op. Br., p. 87).

After raising a number of additional points regarding similarities and differences in regulatory treatment by various commissions, AT&T-C suggested that:

> "None of the foregoing academic debate prompted by the Audit Report should obscure the fundamental fact that access is the Company's most substantial expense and an essential factor in the determination of prices paid by customers. Proper cost accounting requires the inclusion of access charge effects in the Company's cost allocation methodology." (AT&T Op. Br., p. 88.)

AT&T-C then concluded by referring to further testimony of Troxel:

> ". . . The last point that I would like to make on this issue of access charges relates to 'fairness' as a criterion. It is fundamental in any cost allocation system that an allocation method must be applied uniformly across all cost objectives. The California Audit Team's suggestion to remove access charges from allocation bases would arbitrarily and unfairly shunt AT&T's marketing costs from California to other jurisdictions. The fact is that the California Commission has assigned relatively higher access charges than the average of all state jurisdictions. Pretending that these access charges do not exist is fundamentally unfair and would create partially inconsistent allocations throughout the country. (Ex. 235, p. 8.)

According to AT&T-C:

> "The Commission should adopt the expert findings of Mr. Troxel, who determined that AT&T's cost allocation methodologies and processes are appropriate and reasonable, conceptually sound and consistent with generally accepted cost accounting principles (Id. at 9). AT&T's actual amounts of revenue and expense, including access expense, should be retained in the calculation

of its Composite B allocation factor." (AT&T-C Op. Br., p. 89.)

3. Discussion

After reviewing the arguments regarding the use of access charges in the revenue and expense factors for allocating NOMC's expenses to AT&T-C's California operations, we are persuaded by AT&T-C's own witnesses that such inclusion is flawed.

This is especially apparent when reviewing Thiebaud's testimony that AT&T-CH does not include access charges in revenue for allocating its costs. According to Thiebaud: "AT&T Corporate Headquarters certainly does not consider revenue amounts to be anything other than revenue amounts." (Tr. 6387.)

Thiebaud had also explained earlier that "AT&T Communications' revenues are represented [by AT&T-CH] as net of access for the purpose of comparability with other units." (Tr. 6387.)

Since access charges are collected by AT&T Communications companies in message toll rates and then are passed on to the LECs, these charges do not remain as a part of revenues retained by AT&T. Because of the way access charges are treated, there is no more logic to including them in revenues or expenses, than it would be to include taxes in these factors.

It has long been the policy and practice of this Commission to exclude highly variable expense items such as taxes, depreciation, and uncollectibles in determining the proper expense factor for the traditional four-factor method of allocating the headquarters or general office expenses for a multi-district utility or multistate utility operation.

Access charges are not consistently applied and are highly variable from state to state as verified by AT&T-C's own witnesses. Therefore, these access charges should not be included in either revenues or expenses when revenues and expenses are used as factors for allocating home office expenses. AT&T-CH already nets out these charges accordingly and we believe NOMC would be wise to follow the same practice.

In adopting this position we note that DRA has excluded not only the access charges from expenses, but also revenues. This results in only two remaining factors for allocating the NOMC expenses, namely, expenses net of access charges and investment.

This result seems a little severe. While we generally disfavor the use of revenues as an allocation factor, preferring use of customers or usage as a better proxy of the level of business conducted by a utility district or the statewide operations of a multistate utility, a result which leaves only two factors, when three are used for allocations to other states, does not seem proper.

Since DRA's results are now based on only two factors, it is necessary to apply some factor comparable to revenue as a third factor. Referring to DRA Exhibit 201, page VII-4, we note that, AT&T-C's 1985 usage factor of 8.14% is, "By coincidence...almost the same as AT&T-Communications' 1986 revenue factor recomputed to exclude access charges."

Therefore, we will use AT&T-C's 1985 usage factor, which we prefer, as a substitute for the revenue factor exclusive of access charges.

DRA's resulting adjustment for AT&T-C's total California operations is reduced from $5.2 million to $5.0 million and the comparable intrastate adjustment will be reduced from $2.1 million to $1.953 million ($2.0 million rounded) for the elimination of access charges from revenues and expenses for allocating NOMC expenses to AT&T-C.

AT&T-C in its May 31, 1988 comments stated that by substituting the 1985 usage factor instead of its revenue factor would exclude private line usage which contributes 9.2% of AT&T-C's total California revenues.

Accepting the inclusion of the private line revenue percentage with the 1985 usage factor further will reduce DRA's adjustment by about $154,000 for total California and $60,000 on an intrastate basis. The overall effect is a total California adjustment of $4.846 million ($1.893 million intrastate) [$1.9 million rounded]. This result should not be considered as a move on our part to adopt revenues in preference to use as a factor but rather a concern for not omitting a portion of business activity in allocating expenses in this proceeding.

We also suggest that the usage factor, while in this specific instance comparable to 1986 revenues, is generally a better proxy for consistently determining the level of business activity for each state of a multistate operation than revenues which may well be different from state to state because of differing rate structures and levels.

VIII. Gain on Sale of 195 Broadway

On July 1, 1983, the land and building at 195 Broadway, New York City, the headquarters location of the AT&T General Departments since 1916, was sold for $93.1 million, resulting in a net gain of $47.5 million. Subsequently, AT&T earned nearly $3.8 million interest on an investment of the proceeds. AT&T credited $10.4 million to the licensee companies under the license contract agreement and remitted the remainder to the AT&T Foundation, a charitable trust funded and controlled by AT&T. DRA recommends a reapportionment of this gain with 100% going to the licensee companies. The resulting adjustment to AT&T-C on an intrastate basis amortized over a three-year period would reduce the gross revenue requirement by $882,000 annually, for three years.

1. DRA's Position

DRA Financial Examiner, James B. Simmons recommended that, since the Bell operating companies had made license contract payments, including this building's costs since 1916, its customers were entitled to the gain on sale in full.

Initially Simmons had applied a factor of 55% to the full remaining amount, which had <u>not</u> been allocated to the licensee companies and to California ratepayers through PT&T and Pacific Bell in past years. This 55%, as Simmons explained, in response to the following series of clarification questions, was to reduce this adjustment for the impact of license contract adjustments by this Commission over the years.

"Q Now, in your adjustment for the 195 Broadway property, did you take into account these adjustments that the Commission previously made for the license contract --

"A Yes.

"Q -- and give that weight in your ultimate adjustments?

"A Yes, I did. I used the 1980 level of effective disallowance to calculate an allowance factor for the 195 Broadway. And that computes to 55% allowance factor for the 195 Broadway.

"I don't have historical information going back to 1918 to show what the effective equity would be for the effective allowance factor. But I do know that the disallowances were around 50% in the years that I reviewed.

"And, indeed, I think we adopted a 50% disallowance in the interim decision--in the Phase 1 decision in this case, as a representative disallowance factor.

"Q So it is your intention, then, that by use of the 55% factor which you used, that you recognized the fact that the Commission did not necessarily make AT&T [whole] for its 195 Broadway properties over the years?

"A Yes, that is correct." (Tr. 5932-5934.)

Witness Simmons also testified that the 55% factor was not based on a calculation of the actual allowances and disallowances which took place over the years subsequent to 1916, but he felt that "it is a representative and fair allowance factor." (Tr. 5934.)

After AT&T-C had presented its testimony, DRA witness Simmons, in rebuttal, revised his study and recommendation to pass through 100% of the gain allocable to California ratepayers. He explained this revised position by stating that both AT&T-C's 39% factor and staff's 55% factor were understated and he now recommended that 100% of the gain on sale be flowed through for the benefit of ratepayers. He prepared a new table to support his position, which he explained as follows:

> "The schedule clearly shows that the California Public Utilities Commission imposed no disallowances for the years 1916 through 1948. There is a two-year period, 1948-1950, during which the allowed license contract fee was about .84% of estimated revenues. Then, for the period 1950 through 1973, this Commission allowed Pacific a higher amount for license contract expenses than it actually paid to AT&T. This resulted from the fact that allocated actual costs exceeded the agreed-upon rate during that period of 1% of adjusted revenues. Therefore, the Commission's adjustment during this period resulted in an allowance for license contract expense in an amount greater than the amount actually paid by Pacific to AT&T.
>
> "D.83162, issued in 1974, did not identify license contract fees as a specific issue. The next disallowance was made in D.88232 in 1977, wherein a 13.29% downward adjustment was adopted. This previous percentage was composed of 6.04% relating to identifiable investor related expenses, and a 7.25% 'unidentifiable' investor related expenses. The unidentifiable investor interest percentage was challenged by Pacific, and the resulting separate investigation effected a revision to the D.88232 adjustment, in D.90362, to reflect a

> 38.6% reduction. This was the first thorough study of license contract charges. Finally, in D.93367 (1981), a 57% disallowance was imposed. Excluding the Realignment Adjustment, which was a one-time unusual item relating to detariffed items, this disallowance would have been 45%. This final disallowance would have been in effect through 1983, when the building was sold.
>
> "The Team has concluded from these facts that all of the gain resulting from the disposition of the 195 Broadway headquarters building should be credited to ratepayers in the current case, given the fact that this building had an estimated depreciation book life of 40 years, and that, at least for 55 years (1918 through 1973), the CPUC allowed nearly 100% of the billed amount of Pacific's license contract expenses. The relatively short period in which this Commission imposed disallowances for license contract expenses (1974 though 1983), would not reduce the ratepayers' equity interest in the 195 Broadway headquarters property, because, by this late date, the building would have been fully depreciated, and therefore, recovered by AT&T from the ratepayers." (Ex. 238, pp. 42-44.)

DRA's recommendation would reduce AT&T-C's California intrastate gross revenue requirement by $882,000 each year for three years when amortized by an expense reduction as suggested by Simmons (Tr. 6921).

In response to a request from the assigned ALJ, Simmons prepared an alternative calculation to reduce, on a one-time basis, the intrastate rate base of AT&T-C by the amount of the similarly allocated gain. The resulting reduction would be $2,647,000 to AT&T-C's intrastate rate base (Tr. 6925 and Simmons' letter of November 4, 1987).

In its closing brief, at page 12, DRA argues that witness Simmons had noted that the estimated depreciation book life of 195 Broadway was 40 years. For at least 55 years AT&T was allowed nearly 100% of license contract costs billed to Pacific. The brief period of disallowances by this Commission occurred after the building was fully depreciated. Thus, AT&T-C's argument that there were cost underruns in license contract fee recovery is not only erroneous, but would overturn historical Commission precedents of what costs were and were not appropriate for ratemaking purposes.

2. AT&T-C's Position

Using essentially the same historical description of the property in question and the same periods of time for discussion AT&T-C sets forth a substantially different analysis of this proposed adjustment. AT&T-C argues at page 123 of its opening brief that from 1918 to October 1, 1974, the Bell System Operating Companies, including PT&T, paid a flat fee to AT&T General Departments for advice and assistance, pursuant to license contract. By the very nature of that contractual arrangement, there was no allocation to Bell System Operating Companies of specific AT&T General Departments' expense, such as a return on the pre-license contract investment in the 195 Broadway property. However, effective October 1, 1974, the method of payment under the license contract was revised. Each operating company paid an amount that was equal to its allocated share of specific expenses incurred by AT&T General Departments. These specific expenses included a return on investment in property (such as the 195 Broadway land and building) which was employed in performing license contract work.

Accordingly, AT&T-C explained, when a distribution of the gain from the sale of 195 Broadway was made in 1983, the Bell System Operating Companies received payment in proportion to the period of time (1975-1983) in which they had actually been billed for a return on investment in the property. The ratio of those eight years to the 68 years of the building's life resulted in the $10.4 million distribution to the operating companies. The balance was remitted to the AT&T Foundation.

AT&T-C contends that this distribution has never been challenged by any recipient of the gain, stockholder, or regulatory agency. Nevertheless, the DRA auditors have now questioned this well-settled transaction and are requesting a credit to AT&T expense, in the test year and beyond, to compensate ratepayers for perceived inequitable treatment.

AT&T-C argues that DRA's recommendation was based on three critical (and incorrect) assumptions:

> "o That a return on 195 Broadway investment was included in License Contract remittances prior to October 1974;
>
> "o That ratepayers of Pacific Telephone and Telegraph fully reimbursed the costs of the 195 Broadway property from 1918 to 1974; and
>
> "o That, if a credit is due to California ratepayers, it should be fully attributed to AT&T's customers and not shared with Pacific Bell's customers."

The staff auditors, as observed by AT&T-C, simply made a statement in the audit report that "ratepayers funded the entire costs, including capital and return on investment...of the General Departments of AT&T."

AT&T-C argues that the evidence does not support this proposition. AT&T-C witness Conrad J. Ankiel, a District Manager in AT&T's Corporate Headquarters' Chief Financial Officer Department, testified that:

> "There was no allocation of specific AT&T expenses to operating companies prior to October, 1974 under the License Contract method of payment in effect at that time. Accordingly, no allocation of specific gains associated with such periods was appropriate."

In addition, Ankiel testified that on a national basis during the 1950s, 1960s, and early 1970s the General Departments of AT&T were not adequately reimbursed for their expenses by the operating companies. AT&T-C claims that even though the figures provided by Ankiel are national representations, and not dispositive of how many dollars California contributed to this underrecovery, all operating companies paid the same 1% of net service revenues that contributed to the underrecovery.

AT&T-C then provided various references illustrating that for test years 1946, 1964, and 1977 there were, despite DRA's testimony, Commission disallowances for AT&T's license contract services to PT&T.

AT&T also remarked that:

> "As stated in 1977 in Decision 88232, these investor-related adjustments became 'traditional' in a combined disallowance factor of 13.29%; these adjustments were in addition to others that were proposed by Staff. (83 CPUC 149, 199). Accordingly, a review of Commission precedent dispels PSD's unsupportable notion that California ratepayers fully funded License Contract activities for the 1946-1974 period."

As to the 1918-1946 period, AT&T-C asserts that DRA failed to introduce competent evidence to support its claim that license contract expense was fully funded.

AT&T-C also argues that if a credit is determined to be appropriate, then it should be to the predivestiture ratepayers of PT&T. If the Commission determines that some adjustment is appropriate, no more than one-half of such an adjustment should be applied against AT&T's revenue requirement, and the balance against Pacific Bell in its next rate proceeding.

In conclusion, AT&T recommends that the Commission reject DRA's adjustment and adopt as reasonable the 1983 disposition of the gain on sale of the 195 Broadway property. Alternatively, if some adjustment is deemed appropriate, any credit due to customers should be split between AT&T-C and Pacific Bell.

3. <u>Discussion</u>

Following issuance of the Audit Report, AT&T-C on May 5, 1987 filed a Motion to Strike. AT&T-C argued that DRA's recommended disallowance to 1986 test year operating expenses violates the ban on retroactive ratemaking. In support of its argument, it cited several cases for the proposition that the Commission is powerless to adopt the auditors' recommendation for an event that occurred in 1983 (see, e.g., <u>Pacific Tel. & Tel. Co. v Public Util. Comm.</u> (1965) 62 Cal 2d 634, and <u>City of Los Angeles v Public Utilities Commission</u> (1972) 7 Cal 3d 331). AT&T-C maintained that the Commission cannot lawfully alter the results of operations finally adopted in D.85-12-091 (in A.83-01-022, the last general rate proceeding) by adopting DRA's recommended ratemaking adjustment.

In its formal response, DRA argued that none of the case law cited by AT&T-C supports the proposition that a prospective accounting adjustment, such as that recommended here, violates the ban on retroactive ratemaking.

Furthermore, assuming arguendo the merits of AT&T-C's position, DRA believed AT&T-C was estopped from making a retroactive ratemaking argument, due to its failure to obtain prior Commission approval of the 195 Broadway transaction pursuant to PU Code Section 851, and its failure to bring this transaction to the Commission's attention during the last rate case when the ratemaking implications could have been considered on a contemporary basis. As events ultimately unfolded, the details of the transfer were first examined during the audit conducted in connection with this test year 1986 proceeding. Considering all these factors, DRA argued that the Commission should disregard the argument of retroactivity (<u>Citizens Utilities Co. of Calif.</u> (1982) 9 CPUC 197, 207).

On June 16, 1987, the then assigned ALJ denied AT&T-C's motion to strike on the basis that the auditors are not proposing a retrospective adjustment to AT&T-C's pretest year 1986 results of operations, but rather a prospective adjustment to rates adopted for test year 1986 premised on Commission review of a 1983 transaction that the Commission did not have the opportunity to review contemporaneously. This is not precisely the question addressed in Pacific Tel. & Tel. Co. v Public Util. Com. (1965) 62 Cal 2d 634, or City of Los Angeles v Public Utilities Commission (1972) 7 Cal 3d 331, which involved questions of the propriety of refunding portions of rates previously fixed by formal, final Commission findings.

As it later developed, AT&T-C's opening and closing briefs did not dwell at length on the issue of retroactive ratemaking. Instead, AT&T-C devoted its more serious discussion to what it believed were inaccuracies in the technical development and calculation of DRA's adjustment.

For example, AT&T-C noted that prior to 1974 charges under the license contract were not separated in a manner which would specify what portion of the payment, if any, was related to the return on investment on the 195 Broadway property. AT&T-C also correctly noted that PT&T's ratepayers did not fully reimburse the costs of the 195 Broadway property, as billed by AT&T-C to PT&T during the period 1918 to 1974.

However, given the average percentage disallowance to PT&T on license contract billings over the years, we conclude the picture was neither as bleak as AT&T-C claimed, nor as rosy as DRA painted. A review of representative decisions from this period does not validate either perspective.

> AT&T-C's example of D.41416 dated April 6, 1948 (relative to A.28211, PT&T's first application after World War II), wherein this Commission adopted an allowance for general services of AT&T which was about 40% less than the amount requested for such services by PT&T,

was unusual. This adjustment was much larger than the more usual 13-17% disallowance recommended by the staff in subsequent proceedings.

The reason for this substantial adjustment in 1948 was that the staff had excluded 13.5% of the license contract costs at PT&T's then present rates. At proposed rates the amount allowed by staff and adopted by the Commission did not change. However, since AT&T's billings under the license contract were not based on allocated costs, but rather on a percentage of revenue basis - when the Commission in D.41416 - granted PT&T an increase of $22,455,000, AT&T increased its billing to PT&T proportionately as a percentage of the increased revenue granted by the Commission.

By the same token, DRA's claim that from 1950 to 1973, where allocated expenses exceeded the 1% license contract fee allowances, the Commission authorized the higher costs - was only true at present historical rates before any increase was granted. To check these results, we need only to refer to the Commission's formal file in A.49142 PT&T's test year 1967 rate case.

In that proceeding staff, after various adjustments, allocated $14,520,000 for General Service and Licenses. This was $128,000 more than PT&T had listed as expenses <u>at present rates</u>. However, as staff explained in that proceeding:

> "It should be noted that the basis of the staff's estimate for Ac. 674 is the cost of

> services rendered by AT&T while company estimates of Ac. 674 are based on 1% of operating revenue (excluding miscellaneous revenue and uncollectibles). The Commission has on many occasions found that the cost basis rather than the percentage of revenue basis is proper. For example, were Pacific's rate application for $181 million increase in revenue granted, its payments to AT&T under the license contract would increase by approximately $1.8 million with no increase in cost to American." (Ex. 61, p. 11-6.)

> When the Commission issued D.74917 on November 6, 1968, it granted PT&T a revenue increase of $50,200,000 (61 CPUC 53, 91); AT&T license contract billing to PT&T would accordingly increase by $502,000 and the so-called excess staff allowance of $128,000 at present rates was washed out and became a modest $374,000 disallowance at adopted rates. This admittedly was a very small disallowance (about 2%) of the amount billed by AT&T (approximately $14,900,000). Thus, DRA's claim of excess allowance did not occur as a final result in D.74917, [or for test year 1970, D.78851, pp. 339, 340].

From the foregoing discussion we conclude that significant license contract disallowances did occur in 1948 (40%) and for 1981 through 1983 (57%). However, for other years the disallowances, when computed, were very likely in the range of 13% to about 17% based on a formula of identified plus unidentified investor interests; for example, D.67369 issued June 11, 1964 disallowed 16.6% of AT&T's billed license fee expenses to PT&T. (calculated from D.67369, pp. 848-851). In addition, during the early years before 1929 there is no record of a disallowance for these services, and there were many other years, such as test year 1967 described above, when the disallowances, if any, were small.

Therefore, on a judgment basis we will reduce DRA's proposed adjustment for the gain on sale of the 195 Broadway building by 25%. This 25% reduction will likely be somewhat greater than the average disallowances of license contract fees for the period from 1918 through to the time of sale in 1983. However, absent a more accurate calculation on a year-by-year basis which was not provided by either DRA or AT&T-C we are compelled to approximate this figure. We believe that the 25% assumed disallowance exceeds the average actual amount over the years and thus will slightly favor AT&T-C.

In response to AT&T-C's third request that any adjustment be shared with Pacific Bell and applied in its next rate proceeding, we note that AT&T passed on only 11.8% of the gain to the predivestiture Bell Operating Companies, and we are advised by DRA that this amount has already been passed through as a reduction in expenses for Pacific Bell's customers (Tr. 6928 and 6929).

Since AT&T-C, at its own election, retained full control over the balance of the gain and neither PT&T nor Pacific Bell ever obtained productive receipt of these funds, we seriously question the wisdom of requiring Pacific Bell to be further involved in this matter.

Lastly, we will not apply the adjustment as an expense reduction amortized over three years as recommended by DRA. We will instead require that AT&T-C place in a memorandum account the amount of $2,000,000 to be credited to its intrastate rate base. This is based on DRA's intrastate adjustment of $2,647,000 (Tr. 6925) reduced by 25% and rounded to the nearest $100,000 as consistently applied herein.

This adjustment to rate base has the advantage of being entirely prospective and would essentially have the same effect as it would have had if accomplished in 1983. One exception is that customers of Pacific Bell who today use an IEC other than AT&T-C will not share any direct benefit from this gain.

The rate base treatment of this gain also recognizes that AT&T-C will continue in business and will utilize newer buildings in California which will add investment to rate base offsetting this one time memorandum adjustment over time. Therefore, this adjustment resembles as closely as possible a requirement that AT&T-C fold back into its operations a gain on sale of an old building that was largely paid for over time by its customers.

Rate base treatment also tempers the annual revenue requirement to be about one-half that which would result by an expense adjustment amortized over a three-year period as suggested by DRA.

DRA should track the revenue impact of this, and other rate base adjustments determined in this decision, so that appropriate records are available for analysis as the Commission considers alternative ratemaking options for AT&T-C.

IX. AT&T-C Affiliated Transactions

A. AT&T Technologies/Western Electric Company, Inc. Adjustment

Historically, Western Electric Company, Inc. (Western) and PT&T were arms of the same corporate entity in the Bell System. American Telephone and Telegraph Company (American) controlled both PT&T and Western through nearly total stock ownership. Western, in addition to acting as the manufacturing branch of the Bell System, also acted as purchasing agent, supply department, developer, storekeeper, installer, repairer and salvager. Western had several wholly owned subsidiaries, including Nassau Smelting and Refining Company, Inc., Teletypewriter Corporation, and Weco Corporation. Bell Labs was owned 50% by Western and 50% by American. Western was by far the largest manufacturer, installer, and procurer of telephone equipment in the United States, accounting for 80% or more of the total domestic business. PT&T, like other Bell System companies, made most of its purchases from or through Western under a standard supply contract. The prices under this contract were fixed by Western.

Because of the close affiliation of Western and PT&T, this Commission regularly adjusted the earnings on sales by Western to PT&T to allow Western no greater return on its investment than was allowed to PT&T on its utility operations.

At divestiture Western became AT&T Technologies Inc. (Technologies), and all ties to PT&T and its successor Pacific Bell were broken as of January 1, 1984. In addition, as part of the reorganization of AT&T after divestiture, Technologies and several other entities dealing with sales, manufacturing, and international activities were combined.

Technologies is now a wholly owned subsidiary of AT&T. Technologies has three principal lines of business: (1) Components and Electronic Systems, which manufactures electronic components for use by AT&T companies and for sale to unaffiliated customers; (2) Federal Systems, which provides equipment and services to U.S. Government agencies; and (3) AT&T Network Systems, which manufactures and sells communications equipment and services to AT&T Communications companies and to unaffiliated communications companies (principally the former Bell Operating Companies). Technologies provides its products and services in competition with other major equipment manufacturers, including Northern Telecom, Stromberg Carlson, Ericsson, and Siemens. The business Technologies conducts with AT&T Communications constitutes only about 10% of Technologies' total sales and the balance of its sales are made in the competitive market.

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

DRA presented its position on Technologies' adjustment through its then Project Manager, Kevin Coughlan, who had formerly testified in three separate rate proceedings relative to predivestiture affiliated transactions of Western/PT&T, recounted the general history of these studies and adjustments from 1929 to the present. He described the Western adjustment as a process of inputing expense and rate base disallowances for PT&T which would prevent the parent AT&T[10] from earning an excessive profit through the sales of products by Western to PT&T. Witness Coughlan testified that in 1965 and again in 1972 the propriety of the Western adjustment was brought to the California Supreme Court for review. The court in the first instance held that the adjustment, "...as the Commission expressly found herein, produces a fair and reasonable result." In the 1972 review the court's opinion was quoted by Coughlan, as follows:

> "Western must be considered part of the utility enterprise, and its prices should be adjusted to reflect no greater rate of return on its sales to Pacific than Pacific is entitled to earn on its operations."

Coughlan also referred to a subsequent Commission order, D.88232 dated December 13, 1977 in A.55492 in which the Commission stated that Western was not guaranteed a minimum return.

Coughlan then described the principles used for segregating the assets of PT&T previously purchased from Western and allocated to Pacific Bell and AT&T-C at the time of divestiture. These assets were divided into two parts with the bulk of the assets going to Pacific Bell, a subsidiary of Pacific Telesis, and the remainder to AT&T-C, a subsidiary of AT&T. This division was made, according to Coughlan, under the "Plan of Reorganization" which was part of the Modified Final Judgment (Ex. 198, 1-5 KPC).

10 At the time of divestiture (December 31, 1983) AT&T owned 100% of the common stock of PT&T and Western.

Coughlan explained that the portion of Western adjustment that followed the assets that were allocated to Pacific Bell was then amortized over a 13-year period from 1984. Since Pacific Bell had no further ties to AT&T or to Technologies after divestiture, new assets purchased by Pacific Bell from Technologies would no longer be subject to an affiliated transaction adjustment.

For AT&T-C, the affiliated relationship continues to exist. However, purchases of equipment by AT&T-C from Technologies since divestiture have been small, and about 90% of Technologies sales have been made to outside customers. For this reason, Coughlan recommended that the adjustment for assets acquired by AT&T-C at the time of divestiture be amortized over a four-year period with no additions at this time, stating that no material additions to the Western adjustment appear to be merited to date (Ex. 198, 10 KPC). This staff-recommended adjustment would, if adopted, reduce AT&T-C's gross revenue requirement by $2.1 million (Ex. 243).

For the future Coughlan did not recommend elimination of the Western adjustment because the corporate ties between Technologies and AT&T-C continue to exist since both are owned 100% by AT&T. For the years 1984-1986 AT&T-C's construction program was relatively small but this condition could change in the future. Therefore, he recommended that the Commission require AT&T-C to report the following information annually to the DRA and Commission Advisory and Compliance Division (CACD):

a. Annual construction budget.

b. Amount of AT&T-C of California's purchases from Technologies (estimated expense and plant categories.

c. Realized rate of return of Technologies' sales to AT&T-C of California by line of business.

d. Capital structure of Technologies.

2. <u>AT&T-C's Position</u>

AT&T-C argues that since divestiture AT&T affiliates do a majority of their business with non-AT&T customers, at prices that are dictated by competitive market conditions. Also, pursuant to most-favored-customer agreements, AT&T affiliates (including AT&T-C) pay no more for affiliate goods and services than any other customer under comparable conditions. AT&T-C contends that this is a safeguard upon the use of ratepayer money by AT&T-C in making purchases from Technologies, and that DRA's witness Coughlan considered that a condition that would favor ratepayers (Tr. 5279).

AT&T-C's Vice President of Regulatory Matters, Robert B. Stechert, testified that:

> ". . . AT&T Technologies sells its products and services in highly competitive markets. To be competitive, AT&T Technologies must necessarily constrain its return to a reasonable level consistent with its business risk and capital structure as recognized by Mr. Coughlan. The demands of the marketplace thus ensure that AT&T Technologies' prices to all its customers are reasonable. AT&T Communications, which purchases only a small part of the output of AT&T Technologies, automatically benefits from these marketplace constraints. In addition, AT&T Communications is contractually guaranteed a "most favored customer" status, which further ensures optimum pricing benefits in purchases from AT&T Technologies.
>
> "Under these post-divestiture conditions, neither the incentive nor the opportunity exists for AT&T Communications to subject California ratepayers to the burden of "excess" return through the instrumentality of AT&T Technologies. Rather, AT&T Communications' customers are assured that prices for goods and services purchased from AT&T Technologies reflect a reasonable return." (Ex. 221, pp. 10 and 11.)

AT&T-C further contended that its views were supported by the Commission's June 30, 1986 comments filed in FCC Docket 86-111.

Stechert believes the Commission indicated in those comments its belief that the appropriate measures for prices paid by utilities to affiliates are the market prices those affiliates establish in providing services in the marketplace generally. Those are the prices that AT&T pays its affiliates for their services (Tr. 5993). AT&T-C argues that the Commission can best demonstrate its faith in market prices in the current proceeding by adopting Stechert's recommendation to discard affiliated transaction regulation for AT&T because of the prevailing marketplace conditions.

AT&T-C also claims that, while not agreeing to a wholesale withdrawal of traditional affiliate return analysis, DRA Project Manager Coughlan also recognized that conditions have substantially changed for Technologies, compared to those faced by Western in the Bell System. Accordingly, AT&T-C contends that, he testified that a different business risk exists for Technologies and that a higher rate of return is therefore appropriate (Ex. 198, p. 10-KPC).

In conclusion AT&T-C believes the evidence demonstrates that the return of Technologies was lower than the 12.35% authorized for AT&T's California regulated operations in the test year, and below the 12.7% applicable to 1984 and 1985 results. Further, if the adjustment is to be phased out, AT&T believes an 11-year amortization period, which coincides with the Commission's treatment of similar plant held by Pacific Bell, should be adopted in lieu of DRA's four-year proposal. AT&T-C also asks that it not be burdened with oppressive reporting requirements, especially for transactions or individual lines of business within Technologies.

3. Discussion

The Western/Technologies adjustment raises three basic concerns: the treatment of predivestiture assets purchased from Western, the 1984 through 1986 AT&T-C purchases from Technologies, and what level of reporting, if any, should be required to keep the Commission informed as to the reasonableness of prices paid by AT&T-C for the products it purchases from Technologies.

First, with regard to the predivestiture assets which were purchased by PT&T from Western and allocated to AT&T-C at the time of divestiture, the assigned ALJ requested that DRA witness Coughlan prepare a one-page calculation to show the impact on revenue requirement and rate of return of the DRA four-year versus the AT&T-C 11-year and the adopted Pacific Bell 13-year phase-out proposals on a comparable basis (Tr. 5299-5300).

Coughlan's calculation is set forth in the following tabulation:

Western Adjustment

Description	DRA 4-Year Amort.	PacBell[1] 13-Year Amort.	AT&T-C 11-Year Amort.
	(Dollars in Thousands)		
Western Rate Base	($ 3,788)	($ 68,694)	(4,132)
Rate of Return	12.35%	12.52%	12.35%
Net Revenue Requirement	(468)	(8,600)	(510)
Net Revenues	628	3,194	228
Change in Net Revenue Requirement	(1,096)	(11,794)	(738)[2]
Intrastate Rate Base	374,921	10,005,119	374,921
Incremental Rate of Return	0.29%	0.12%	0.20%

Notes:

1 Pacific Bell data from D.86-03-049.

2 $\frac{[\$1.388 \text{ million}]^{3}}{1.8813^{4}}$ = [$.738 million] = [$738,000]

3 AT&T-C Testimony of Maud E. Thiebaud. (Ex. 229, p. 32.)

4 Net to gross Multiplier.

A careful review of Coughlan's calculation and tabulation reveals that because of AT&T-C's relatively small intrastate rate base a four-year amortization of the predivestiture Western adjustment would result in a $1.096 million revenue reduction ($2.1 million gross revenue reduction, previously discussed) and a .29% reduction in rate of return.

The 11-year phase-out proposal of AT&T-C would moderate the annual adjustment to $.738 million net and $1.4 million gross revenue (rounded) with a .20% reduction in rate of return to AT&T-C over 11 years. The impact of this adjustment is somewhat larger than that for Pacific Bell using a 13-year phase-out of the assets purchased from Western because of its much larger rate base and earlier, thus longer (13-year) amortization.

We will adopt the 11-year amortization of the Western adjustment suggested by AT&T-C for the remaining (predivestiture) assets purchased by the PT&T and segregated to AT&T-C on January 1, 1984. This treatment will spread the ratepayer benefits over the useful life of the property involved and will also assure that AT&T-C receives the same treatment for this adjusted property as has been accorded to Pacific Bell.

Concerning the 1984 to 1986 assets purchased by AT&T-C from Technologies, DRA and AT&T-C both agree that no adjustment for AT&T-C's purchases from Technologies during this period be made. We will adopt that recommendation.

With regard to the tracking of future purchases by AT&T-C from Technologies, we will adopt the annual reporting requirements requested by DRA, except for the annual determination of "Realized rate of return of Technologies sales to AT&T-C of California by line of business." The balance of the reporting on sales by Technologies to AT&T-C requested by DRA does not appear to be a significant burden to AT&T-C and Technologies. Regarding the realized return on lines of business, we will only require that AT&T-C and Technologies maintain their respective accounting records, including such memorandum accounts as necessary, in a manner which would permit the development of such calculations when AT&T-C's intrastate rates are next determined.

B. American Transtech

American Transtech is a wholly owned subsidiary of AT&T which services securities (stocks and bonds) and provides a variety of shareholder-related services for AT&T and numerous other companies. The work of American Transtech for AT&T, according to

DRA auditors, includes administrative support for the AT&T Opportunity Calling Program, including tabulation of call information, handling customer inquiries, and mailing credit status reconciliations; direct telemarketing solicitation for selection of AT&T in equal access areas; preparation of abandoned property reports; data security services, including outside storage of disaster recovery files; record-keeping functions relating to savings plans; and preparation of 1099 tax forms. DRA pointed out that American Transtech also performs marketing, data security, and employee relocation services for AT&T Information Systems, and shareowner services for Corporate Headquarters and the seven regional holding companies which resulted from divestiture. American Transtech also maintains bond records, handles stock transfers, prepares tax information reports, and administers bond calls and maturities for AT&T-CH, according to DRA auditors (Ex. 201, p. X-7).

Except for certain new services, the work of American Transtech for AT&T is essentially the same as that performed by the Stocks and Bonds Division of AT&T's General Department prior to divestiture.

1. DRA's Recommendation

The DRA audit team computed the rate of return employed by American Transtech on work performed for AT&T and found it to be far in excess of that found reasonable for AT&T-C. Therefore, it recommended that these earnings be adjusted to achieve a rate of return equal to that authorized by this Commission for AT&T-C. The DRA audit team's recommendation would result in an adjustment of $217,000 for total California and $100,000 (rounded) for intrastate operations.

On short notice, DRA auditor James B. Simmons recommended that this adjustment be increased (doubled) because of revisions made in supplemental testimony and development of a new table (Ex. 203). AT&T-C's counsel objected to these last minute changes claiming that the information relied on by the staff for these adjustments was sought and received by staff "...seven or eight months prior to the supplemental testimony date." Then AT&T-C's counsel moved to strike this revision and the motion was granted subject to verification that the DRA auditors had this information for 45 days or more and, therefore, it could have been incorporated in DRA's supplement to the audit report or otherwise provided to AT&T-C at least 10 days before the July 27, 1987 hearings (Tr. 5452). Following this exchange DRA confirmed its previously recommended adjustment of $100,000.

2. <u>AT&T-C's Position</u>

AT&T-C argues that no adjustment to the expenses of American Transtech is appropriate because its services to AT&T amount to about 26% of its business and the remaining 74% is with unaffiliated companies (Ex. 221, pp. 17-18). AT&T-C claims that it pays American Transtech prices that are no higher than those paid by other customers (Tr. 5977).

AT&T-C witness Stechert testified that:

> "American Transtech's prices for its services to AT&T are demonstrably reasonable. Prior to the formation of American Transtech, AT&T's in-house shareowner services expense was $11.08 per account. In 1986, American Transtech's shareowner services price to AT&T was $3.80 per account -- constituting a reduction in AT&T's shareowner services expense per account of about 66%.
>
> "More fundamentally, AT&T Communications' customers are protected by the competitive marketplace -- and by American Transtech's beneficial pricing practices -- from any likelihood of unreasonable expenses for shareholder services. The prices charged AT&T are equal to or less than the prices charged any of American Transtech's other customers." (Ex. 221, pp. 18-19).

Moreover, AT&T-C argues that, as a practical matter, the auditors' recommendation was mooted by the receipt into evidence of

American Transtech's reduced test year 1986 billings to AT&T for shareowner services. As a result of competitive pressures, American Transtech's prices for these services in 1986 were on average reduced by 32.4% from 1985 levels, and its return on investment decreased by 76.3% (Ex. 248; Tr. 5971-72).

Noting the dramatic effects of DRA's proposed use of 1986 data (a reduction of 93.5%, to approximately $14,000 before separations), AT&T urges the Commission to reject DRA's proposed adjustment and adopt the American Transtech expense incurred in the test year.

DRA counters AT&T-C's argument claiming that AT&T-C's analysis (of the 1986 reductions) ignored the fact that the excess 1985 amount of rate of return was included in the test year estimates and therefore an adjustment was still needed to reflect excessive 1986 prices paid by ratepayers. DRA further contended that the existence of excessive returns in the present competitive environment supports the retention of affiliated transaction regulation, at least for the present.

3. Discussion

The work performed by American Transtech for AT&T does not appear to be subject to significant risk. It is service work that can be planned and carried out on an ongoing basis. It is not subject to even the pressures associated with manufacturing caused by material shortages, on the one hand, or overproduction of similar equipment by other manufacturers, on the other hand. In providing shareholder services, American Transtech can establish realistic and definite work schedules for meeting the needs of its AT&T affiliated customers being reasonably sure that the work will be needed and performed as scheduled.

American Transtech received nearly $25,000,000 in business from AT&T for servicing securities in 1985. AT&T-C has not persuaded us that rendering these services, on an affiliated basis, is any more risky than the utility's interLATA telephone business.

In addition, this Commission and the courts have long held that such services, when provided by an affiliate, should not enjoy a greater return than that authorized for the utility itself (D.67369 dated June 11, 1964, Case 7409). The investor related adjustments made in D.67369 were upheld as reasonable by the California Supreme Court (62 C 2d 634, 662-663).

We will adopt DRA's recommendation of a $100,000 expense adjustment for the investor-related services of American Transtech on AT&T-C's intrastate operations.

C. <u>Bell Labs' R&D</u>

Bell Labs remains the basic research arm of AT&T, as it was before divestiture, and conducts about $2 billion of R&D each year. AT&T's annual budget for R&D and for "Fundamental Research" for the AT&T Communications Sector is $289.2 million in test year 1986 (Ex. 201, p. XI-1). These funds are used by Bell Labs to perform Fundamental Research into solid state physics and other basic sciences, to advance the means by which to communicate or transmit ideas and intelligence. Bell Labs also carries on applied research called R&D into integrated and other existing circuit technology, telephony, and optics to expand, test, and develop new methods and products for communication systems. AT&T-C's contribution to this overall R&D effort approaches $26 million per year for its total California operations (Ex. 201, p. XI-1).

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

DRA witness Maurice F. Crommie analyzed the test year R&D budget for Bell Labs as allocated to AT&T-C's total California operations in the amount of $16.5 million for R&D, and $9.1 million for fundamental research ($6.9 million and $3.6 million, respectively, on its intrastate operations) (Ex. 201, p. XI-1). From his analysis Crommie later determined that Bell Labs realized $3.6 million or a return on investment of 16.2% for these services contrasted with the 12.35% last authorized by this Commission for AT&T-C. He then adjusted the $3.6 million of realized return to $2.7 million to achieve the same return as that authorized for AT&T-C (12.35%) for test year 1986 as follows:

Return on AT&T-C R&D and
Fundamental Research Program
($000's)

	AT&T-C	DRA	AT&T-C Exceeds DRA Amount	Percent
R&D	$2,546	$1,941	$605	31.2%
Fund Rsch.	1,032	787	245	31.1
Total	$3,578[1]	$2,728[2]	$850	31.2%

(Source Ex. 202, p. MFC-1)

Notes:

1 Based on Return on Investment (ROI) of 16.2%.

2 Based on ROI of 12.35% allowed in Commission D.86-11-079.

Under cross-examination Crommie did agree that the Research, Development and Demonstration (RD&D)[sic] program would provide a direct benefit to California customers of AT&T-C. He also agreed that the blanket 50% disallowance previously applied by this Commission to Bell Labs, prior to January 1, 1984,..."no longer might be necessary." He agreed that the composite allocation factor used to allocate costs of Bell Labs to AT&T-C and other communications entities was reasonable. He also stated that he had been informed about one other decision (unspecified as to what state or communications company involved) where the rate of return allowed Bell Labs was the same as that allowed to the company.

2. TURN's Position

TURN did not address the reasonableness of Bell Labs' charges to AT&T-C in Phase II of this proceeding, but in Phase I it did recommend a full disallowance of the entire amount requested by AT&T-C for R&D and fundamental research (D.86-11-079 mimeo. pp. 110-111). TURN in Phase I argued that the company has the burden of proving that the projects will be used and useful in a reasonable timeframe, that AT&T-C has not done so and, therefore, the entire amount should be disallowed.

3. AT&T-C's Position

AT&T-C argues that Bell Labs operates in an international research environment in competition with numerous industrial, governmental, and academic research entities, and that AT&T Communications Sector funds approximately 40% of Bell Labs' fundamental research and 20% of its R&D work. Bell Labs does research for the Federal Government, Technologies, and other AT&T entities. AT&T-C contends that after a thorough review of the nature, funding, and benefits of Bell Labs' work DRA auditor Crommie found that AT&T's expense for research performed by Bell Labs was reasonable and beneficial to ratepayers, except for the minor adjustment to the rate of return earned by Bell Labs.

AT&T-C argued against the Commission's long-standing 50% expense adjustment for Bell Labs' R&D which reflected the predivestiture 50% ownership of Bell Labs by Western. Since Technologies now contributes its fair share to Bell Labs' R&D efforts, the 50% adjustment is no longer appropriate. AT&T-C recounted, at page 103 of its opening brief, that: "As Mr. Crommie and AT&T witness Stechert agreed, this 'primary benefit' test is no longer applicable as a result of post-divestiture changes in corporate structure and funding practices."

AT&T-C witness Stechert had testified that business risk should be taken into account:

> "...The Audit Staff's proposal to apply a rigid return-on-investment analysis to AT&T Bell

> Laboratories expenses is especially inappropriate in this proceeding. Essentially, the Auditors seek to impose for the first time a Western Electric-like adjustment in the research area that would constrain an AT&T Communications affiliate with differing business risk and financial structure at the very time the same Audit Staff recognizes that such an adjustment in the manufacturing area is likely to reflect little or no activity. This fundamental inconsistency in the Audit Staff's recommendations strongly militates against the proposed disallowance for AT&T Bell Laboratories expense.
>
> "My recommendation is to reject the Auditors' proposed disallowance. The competitive market effectively guarantees that AT&T Communications will continue to pay no more than the reasonable costs for research work performed by AT&T Bell Laboratories." (Ex. 221, pp. 15-17.)

AT&T-C also contended that Crommie agreed that Bell Labs faces a substantial business risk that is inherent in all research activities, that the scientist does not know, by definition, how a research activity or experiment will ultimately come out (Tr. 5655).

4. __Discussion__

While we agree that the simple 50% disallowance which was commonly adopted for the R&D efforts of Bell Labs before divestiture should no longer apply, we are not convinced that, under the present 100% ownership by AT&T (which also owns 100% of Technologies) there is potentially any difference in the real beneficiaries of the R&D performed by Bell Labs.

It could turn out that Technologies will be the greatest beneficiary of the Bell Labs' research in the future, and Technologies' sales are, at least at the present, predominantly outside of AT&T.

Therefore, the concerns raised by TURN in Phase I of this proceeding that no proof had been advanced that the research being performed by Bell Labs would be used and useful in a reasonable period of time to the ratepayers of AT&T-C are still valid. Witness Stechert brought no new evidence to Phase II of this proceeding to set aside TURN's concerns and arguments. In fact for its argument AT&T-C appears to have relied solely on a statement made by DRA witness Crommie in response to a question from AT&T-C's counsel, that he agreed that there will be a direct benefit to California customers of AT&T-C as a result of the expenditures for research and development (Tr. 5647-5648).

DRA's current audit study and treatment of the allowable funding of Bell Labs are a significant departure from the more traditional disallowance of allocated costs for a sizeable portion of the Bell Labs' effort. DRA's current analysis and recommendations for Bell Labs' expenses are also different from its analyses of energy utilities' research, design, and development expenses. For those expenses DRA performs a program-by-program analysis and then advances recommendations to disallow those programs or activities which are not likely to be, or become, used and useful to ratepayers in the near future. An example of DRA's more specific analysis of energy utilities' research, design, and development activities can be noted by reviewing the discussion at pages 83-90 of D.87-12-066 issued December 22, 1987 in Southern California Edison Company's test year 1988 general rate case.

In response to TURN's Phase I concerns, we hereby place AT&T-C on notice that we will expect, in any future rate proceeding or investigation, a more detailed and affirmative showing by AT&T-C that the R&D efforts of Bell Labs are or will be beneficial to AT&T-C's customers and will be used and useful in a reasonable period of time. We will also expect AT&T-C to address our concerns, that Technologies with about 90% of its sales to outside markets will be the predominant beneficiary of this overall R&D effort.

While we agree with DRA witness Crommie that it is often impossible to predict the outcome of R&D activities, and that poses the risk of uncertainty, such risk is clearly different from business risk.

There is no record that would suggest that Bell Labs will not be compensated for any failing projects. Absent such evidence, it follows that Bell Labs will receive income equal to its established budget, regardless of the outcome of its R&D projects. Thus, Bell Labs' R&D efforts have less business risk, if any, than AT&T-C itself would incur in its intrastate utility telecommunications operations.

Based on this discussion DRA's recommended modest adjustment, to allow Bell Labs to earn the same return on its investment for R&D activities as was authorized for AT&T-C, is the minimum reasonable adjustment we should consider. We will therefore reduce AT&T-C's total California expenses by $900,000 and its intrastate expenses by $300,000 (rounded) as recommended by DRA.

X. Marketing - Use of 1985 v 1984 As a Base For Test Year

Marketing may be defined for the purposes of this proceeding as the aggregate of functions involved in transferring goods and services from producer or supplier [in this case, AT&T and AT&T-C] to consumer [in this case, a consumer of interexchange long distance telecommunications services].

In D.86-11-079 the Commission adopted $126,623,000 as reasonable commercial expenses for test year 1986, consisting of $22,393,000 for advertising and $104,230,000 for marketing activities on a total California basis. In AT&T-C's application for rehearing of D.86-11-079, it requested that the Commission substitute 1985 in lieu of 1984 as the baseline year for calculating the appropriate marketing expenses for test year 1986.

The Commission, by D.87-04-041 dated April 8, 1987, did grant limited rehearing on this remaining marketing issue based on the following discussion in that order:

> "...for reasons of equity, we have decided to allow AT&T-C to present argument, based on the existing record, on the question of whether 1985 is a more appropriate year than 1984 to begin our determination of allowable marketing expenses for test year 1986. We caution AT&T-C that the limited rehearing we grant on this issue is solely for the purpose of allowing the parties to address the above question, and to receive into evidence figures describing specific 1985 expenditures. During this rehearing, we will not allow any additional testimony concerning justification of those or any other expenses, nor will we allow additional testimony on any other marketing/advertising-related issue. Our focus now should be the OII. To ensure that Phase II of this proceeding is not prolonged any more than is absolutely necessary to give AT&T-C its day in court on this issue, we will limit AT&T-C's showing to one hearing day, and the PSD's and TURN's showings to one-half day each.
>
> "We note that by granting this limited rehearing, we are not implying any preconceived commitment to moving to a 1985 base. In making the ultimate decision, we will weigh AT&T-C's new 1985 evidence against the existing state of the record on the cost-justification question, reflected in Findings 24 and 26 of D.86-11-079, as modified below. Such a balancing of equities is crucial to reaching a decision which is fair to both AT&T-C and its California ratepayers." (D.87-04-041, mimeo. pp. 2 and 3.)

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

DRA did not recommend that 1985 be used as a base year for marketing, claiming there was no evidence presented by AT&T-C to show that 1985 provided a better year than 1984 for purposes of estimating 1986 marketing expenses. DRA argued that its analysis of 1985 pointed to the opposite conclusion and major adjustments would be necessary to 1985 expenses should this be used as the representative or normal year.

DRA's Financial Examiner Francis Fok testified that three significant adjustments would need to be made to AT&T-C's booked number for 1985, prior to using it for ratemaking purposes. He then itemized these adjustments as follows:

> "a. Equal Access;
> b. Billing and Collection; and
> c. Force Reduction Expenses." (Ex. 246, p. 3.)

Fok explained the need for these adjustment as follows:

> "Equal Access stemmed from the Modified Final Judgement of the AT&T divestiture proceeding. All telephone customers were to select a long distance telephone company as their primary provider. Access to such selected provider's service was to be automatic (i.e. not having to dial a long access code). Cutovers primarily took place in 1985 and 1986. After being cutover, customers who wish to switch to another long distance company will have to pay a service fee to their local exchange telephone company." (Ex. 246, p. 3.)

Fok determined that AT&T-C expended significant sums of money to promote subscription of customers in order to maintain and/or expand its market share, and the audit team recommended that such expenditures for equal access be excluded for ratemaking purposes because: Expenses to maintain or increase the company's market share in the face of competition had not been considered appropriate by this Commission, and this promotional program was a non-recurring, unusual, and significant event over and above a regular marketing effort in a normal year. Fok opined that the unusual nature of these (equal access) expenses made them unsuitable for inclusion in ongoing rates developed for a test year (Ex. 246, p. 4).

Fok also explained the rationale for his billing and collection adjustment as being consistent with the deferral and capitalization of billing and collection developmental costs by DRA witness Simmons (Ex. 246, p. 4).

Regarding his force reduction expense adjustment, Fok explained that those are expenses associated with early retirement incentives, severance payments, and employee relocation expenses incurred in AT&T-C's attempts to reduce its operating costs. He believed that the benefit of such a large scale reduction extends beyond the year in which these force reduction costs were incurred (Ex. 246, p. 5).

Using the 1985 recorded base amount with these adjustments, including a three-year amortization of employee force reduction expenses, DRA arrived at a 1986 marketing expense allowance of $86.89 million which was lower than the booked 1984 marketing expense amount of $96.460 million and $17.34 million lower than the $104.230 million already adopted for test year 1986 by the Commission in Phase I (Ex. 246, Appendix B and D.86-11-079, p. 90).

DRA argues that the booked 1985 marketing expenses without these adjustments, for equal access, capitalized billing and collection and three-year amortization of employee force reduction expenses, would reflect marketing expenses at their highest in this three-year period. A peak year is not suitable as a representative year (DRA Op. Br., p. 32).

As a further argument against a higher marketing base, DRA challenged AT&T-C's claim for the need of added marketing activities to cover the continuing customer change of carrier selection. DRA stated that:

> "On December 7, 1987, AT&T-C distributed a response to an ALJ request for further information on the alleged 20% 'churn' rate to which AT&T-C witness, Mr. Fuller, testified. The 'churn' rate is the continuing customer change of carrier after the initial selection

> process is over. AT&T-C's response provided support for a rate of 8.8%. Testimony that the rate is 20% was not substantiated. It may be that some degree of 'churn' will always be present after the equal access cutover. However, staff would expect all carriers to address retaining customers, as well as wooing new customers, in normal marketing strategies without additional costs. Whatever the churn rate may be in 1986 and future years, the scope and size of customer selection in 1985 and early 1986 would not reoccur." (Op. Br., p. 31.)

DRA thereby concluded that 1984, rather than 1985, was a more representative base year for determination of reasonable marketing expenses for AT&T-C in test year 1986.

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

TURN appeared in Phase II, and brought back Joseph H. Therrien, Vice President of Marketing Communications of Winston Management, Inc., as its witness on the marketing issue. Therrien had testified on the marketing issue for TURN in Phase I of this proceeding and contributed effectively to the record on the marketing issue at that time. On the question of substitution of 1985 for 1984 as a base for estimating, Therrien testified as follows:

> "As far as I can see, AT&T is trying to substitute one set of hollow, unjustified figures for another. All we can say for certain about the 1985 number is that it's higher than the 1984 number. It suffers from all the same infirmities I discussed in my initial testimony:
>
> "First, there has still been no effort to disaggregate this figure to show that any or all of the programs or activities it covers are beneficial or cost-effective. While I recognize that the Commission has restricted the introduction of background information that might justify 1985 expenditures, it seems clear from the cross-examination and ALJ examination of AT&T witness Thiebaud that the utility <u>still</u> does not prepare these basic analyses. For example, AT&T cannot distinguish costs of

servicing existing customers from those of marketing for new ones (See generally Tr. Vol. 54, at 6642-6678). AT&T-C still hasn't justified one cent of the $60.5 million they claim to have spent in 1985.

"More broadly, AT&T-C has never justified their astronomical marketing and advertising expenditures -- for 1984, 1985 or any year -- which all seem directed toward maintaining the utility's 80+ percent market share. Normally, the client for advertising and marketing services would demand extensive justification for such expenditures. Yet California ratepayers are being asked to sustain expenditures for marketing and advertising that have never been justified to anyone, and seem far too high. In my opinion these costs are better borne by AT&T's shareholders.

"Finally, the utility itself has denied that 1985 was a business-as-usual year, that otherwise might have been claimed as a more secure baseline than the tumultuous first year after divestiture. Instead, AT&T points out that marketing approaches and organizations are still undergoing major changes -- the take-back of billing and collection is a major example that is continuing in 1987 and beyond..." (Ex. 247, pp. 3 and 4.)

Therrien continued by stating that:

"Just because AT&T spent the money doesn't make it reasonable. In fact, huge increases for poorly-defined projects all but guarantee that the money would have been poorly spent." (Ex. 247, p. 4.)

Then he concluded his testimony with the following recommendation to the Commission:

"AT&T has provided nothing to indicate that 1985 represented a post-divestiture business-as-usual baseline, nor that any part of the spending in that year was cost-justified by the utility's management. Under these circumstances, the Commission has no basis for substituting a 1985 base for the 1984 base developed in D.86-11-079." (Ex. 247, pp. 4 and 5.)

TURN in its brief emphasized that no showing had been made by AT&T-C, that the expenditures were necessary to maintain or expand the utility's 80% market share. TURN argues that AT&T-C has met no reasonable standard of proof regarding its marketing budget.

TURN's counsel concluded by arguing that, while the over-generous budget adopted in (D.86-11-079) has become final, the Commission can still affirm its responsibility by refusing to substitute AT&T-C's unsupported 1985 data as a basis for 1986 expenditures. TURN recommends that the Commission issue a finding that this new data is unusable, and direct AT&T-C to produce better justifications in its next proceeding (Brief at p. 3).

3. <u>AT&T-C's Position</u>

AT&T-C, in its opening brief at pages 52-54, stated that in its Phase I order, the Commission made an interim award of $104.2 million on a total California basis, resulting in a $44.7 million marketing expense allowance on an intrastate basis. AT&T-C calls attention to the fact that the Commission used an unadjusted 1984 baseline plus a consumer price index (CPI) inflation factor in arriving at its test year marketing expense allowance (D.86-11-079, pp. 90-91).

AT&T-C argues that, in its application for rehearing of the interim decision, AT&T requested the Commission to substitute 1985 as the baseline year for its calculation of a final award for marketing expense. AT&T believes that it showed that the Phase I record evidence--particularly the undisputed testimony of Mr. Zemke of the Marketing Regional Vice President Staff--demonstrated that, of the two years, 1985 was far more representative of 1986 conditions. The company's first year of operations was 1984. AT&T-C also alleges that at the beginning of 1984, PT&T had not assigned a stand-alone sales force or adequate information systems to AT&T at divestiture, AT&T had not developed its own customer service capabilities, and the first carrier selection activities associated with the deployment of equal access were still months away. As 1984 passed, AT&T claims that it gradually built up its sales force and support systems, deployed its first account inquiry and service order entry work centers, and began to contend with the difficult competitive challenges inherent in carrier selection. AT&T-C argues that all of these activities were reasonable and necessary to meet customer needs. The critical fact, it says, is that these activities were implemented gradually, and often late, in the year; because these expenses were for only a partial year, the use of actual 1984 expense as a baseline severely understates a full year's worth of expense for these functions.

By contrast, AT&T-C argues that the 1985 expense was comprised of the true annual expense of activities started in 1984, together with increases in force and facilities due to the further deployment of customer service work centers and management information systems, and due to the FCC's mid-year alteration of the allocation procedures for so-called "default" customers. These customer support functions and market conditions continued through 1985 and 1986. Accordingly, 1985 should be substituted for 1984 in the Commission's methodology.

In its application for rehearing, AT&T estimated that the 1985-plus-inflation award would be $139.8 million, on a total California basis, or $61.0 million intrastate. Because no party had addressed 1985 actual marketing expense exclusive of advertising, there was no Phase I record support for AT&T's estimate. In D.87-04-041, the Commission granted a narrowly focused rehearing limited, AT&T-C contends, to receiving into evidence AT&T's 1985 booked marketing expense. In Phase II, AT&T believes it has shown, with DRA's concurrence, that its intrastate marketing expense was $60.512 million in 1985 and that $62.69 million is the award that would result from use of an unadjusted 1985-plus-inflation methodology.

While other AT&T witnesses briefly discussed marketing issues, Mike D. Fuller, Revenue Support Manager of AT&T's Western Region Marketing Office, and Controller Maud E. Thiebaud testified in support of its position that 1985 was a more representative baseline than 1984 for a test year 1986 marketing allowance. Fuller disagreed with DRA witness Fok that carrier selection was a "non-recurring, unusual, and significant event over and above the regular marketing program." Fuller instead opined that carrier selection did not end in 1985 but "continues each time service is ordered, expanded, changed, or moved" (Ex. 245, pp. 2 and 3). Fuller concluded.

> "To be competitive in the California marketplace, carriers must maintain ongoing programs which provide useful information to customers and facilitate the selection of their long distance carrier. Because customers have the freedom and the power to change their carrier of choice whenever they wish, routine and vigorous marketing to these customers is now a permanent condition in the competitive interexchange market." .(Ex. 245, p. 5.)

On cross-examination, Fuller explained that, in addition to all the activity associated with the normal additions and deletions of lines, AT&T-C would also experience a large customer reselection of IECs after equal access. He called this reselection "churn" and estimated it to be 20% over an unspecified period of time. DRA's counsel and the assigned ALJ questioned the 20% figure and asked Fuller to verify it and over what period it occurred (Tr. 7037-7044).

After further review by Fuller, AT&T-C responded by letter on December 7, 1987, to the ALJ, that the "churn" rate was greater than 8.8% for the period of October 1984 through September 1987. For the first nine months of 1987 the verifiable churn rate was approximately 3.2%, and in a separate workpaper, provided by Pacific Bell to AT&T-C, an estimate of 4.8% churn was made for the full year 1987.

Fuller was also questioned about AT&T's marketing practices before and after initial carrier selection. Fuller responded as follows:

> ". . . If your question is did we send reballot mail pieces and telemarketing to people that already selected us, no. That's an irritation to the customer, so we did not do that.
>
> "If the question is do we have other activities that continue to focus us as the favorable vendor, as perhaps a mail piece that informs them of other services that have been offered or a rate reduction that now allows them better use of their monthly phone bills, we continue to do those kinds of things, and to us that's also carrier selection-related behavior." (Tr. 7050-7051.)

Fuller was also asked how many direct mail pieces were sent to California in 1986. He responded in Ex. 252 as follows:

> "Approximately 5.8 million carrier selection letters were mailed to Californians in 1986, including 1.6 million acknowledgement and confirmation notices following selection. The average cost per item including postage was 40 cents for the residential mailings and 69 cents for business mailings."

Thiebaud and Fuller were questioned on what advantages the large number of AT&T-C's smaller customers could expect to gain by a 5% to 10% saving (25¢ to $1) on AT&T-C's monthly bills of $5 to $10 or less, when LEC conversion charges and other costs would offset the savings of switching for a year or more. Fuller responded that to attract AT&T-C's customers, other IECs were willing to reimburse potential customers for the LEC's carrier conversion charge of \$5.26.[11]

Thiebaud had earlier presented testimony confirming AT&T-C's recorded 1985 marketing expense of \$138.9 million on a total California basis and \$60.5 million on an intrastate basis (Ex. 229, p. 36 and Ex. 244, p. 5).

Thiebaud then recommended that the Commission totally reject DRA witness Fok's recommendations for reductions of the 1985 baseline amount. She opined that DRA had not challenged the accuracy of the recorded amounts and she recommended their adoption as the 1985 baseline. Accordingly, using the addition of an

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11 He provided two written examples of such offers as part of Ex. 252, and explained that:

> "In addition to the attached examples, the following interexchange carriers were surveyed by telephone on October 12, 1987:
>
> Allnet
> Execulines, Inc.
> MCI
> Starnet
> US Sprint
> Western Union
>
> "Each of these interexchange carriers offered to reimburse the \$5.26 conversion charge, and one, Allnet, offered an additional \$5.26 reimbursement to convert back to the original carrier if a customer was dissatisfied with Allnet's service.
>
> "Considering the direct mail examples, the telephone survey results, and the fact that Pacific Bell and General Telephone provide at least one free carrier change in the first 180 days following central office conversion, the \$5.26 conversion charge is <u>not</u> an effective impediment to customers interested in trying new interexchange carriers." (Ex. 252, p. 2.)

inflation factor, as the Commission had done in D.86-11-079, she recommended adoption of $143.9 million on a total California basis and $62.7 million on an intrastate basis as AT&T-C's allowance for 1986 marketing expenses (Ex. 244, p. 5).

Under cross-examination Thiebaud did agree that once carrier selection had been made, there were likely a significant number of customers who were neither moving nor dissatisfied with their carrier and "we probably don't have to worry about them." However, she deferred to Fuller questions on how AT&T-C dealt with customers who, for whatever reasons, would have to reselect a carrier (Tr. 7000-7001).

Thiebaud did confirm that "by about September 1986, a large majority of equal access had been completed. We still are in the process of going through the equal access conversion." (Tr. 7005.) In addition, AT&T-C did not present any evidence that it was losing significant numbers of customers to other IECs, irrespective of the other IECs' offers to cover the reselection charges imposed by the LECs.

Notwithstanding the concessions of Fuller and Thiebaud, AT&T-C argued: that Fok's adjustments to the 1985 baseline figure were inappropriate; that Fok's billing and collection adjustment would be mooted by the decision on 1986 audit adjustment; that carrier selection activities were similar for both 1985 and 1986; and that customers were perennially free to reselect primary IECs and, any many did so. AT&T-C also argued that 1985 and 1986 were very similar years reflecting very similar marketing requirements (AT&T-C Op. Br., pp. 55 and 56).

Finally, AT&T-C argued against Fok's proposed adjustments for force reduction expenses on the grounds that such reductions in force "in 1985 were routine and ordinary, rather than being of the 'large scale' perceived by Mr. Fok." AT&T-C also pointed to Thiebaud's testimony that the average number of employees in the marketing department was approximately equal in 1985 and 1986 and that salary expense for all groups, whose costs were assigned to marketing, increased from 1985 to 1986.

AT&T-C then urged that the Commission reject all proposed adjustments to 1985 marketing expense in its determination of the test year marketing award (Op. Br., p. 67).

In its closing brief AT&T-C renewed its arguments against DRA's proposed adjustments, and also challenged TURN's witness Therrien. AT&T-C argued that Therrien's career experience was in advertising, not marketing, and advertising was not an issue in Phase II. AT&T-C also contended that during the two years of litigating this proceeding Therrien never reviewed any of its marketing department's extensive confidential business records or data, never requested to visit any AT&T work center, and never interviewed a single marketing representative of AT&T.

Simply put, AT&T-C argues, Therrien was uninformed on the specifics of AT&T's marketing operations and failed to recognize the deployment and growth in customer service and support functions that required budget increases over the 1984 level (Cl. Br., pp. 20-21).

4. Discussion

In AT&T-C's 1984 test year proceeding, the Commission considered AT&T-C's budget request for combined marketing and advertising of $182,050,000 representing approximately $13.50 for each of the then roughly estimated 13.5 million access lines. It also considered its staff's recommended combined marketing and advertising allowance of $53,000,000 representing about $3.93 per access line. In D.84-06-111 the Commission determined that:

> "...the staff's proposed allowance of $53,000,000 for advertising and marketing, while only 29% of AT&T-C's $182,050,000, would still provide for expenditure in 1984 the not inconsiderable sum of $3.93 for each of the state's 13.5 million access lines. Recognizing the unusual circumstances faced by AT&T-C in establishing itself in the newly competitive field of interLATA communications the

Commission finds, by exercising its expertise and judgment, that $5 per access line, or $67,500,000, for total California AT&T-C marketing and advertising, is a reasonable allowance for advertising and marketing expense combined." (D.84-06-111, mimeo. p. 96.)

In Phase I of this application the Commission had before it AT&T-C's combined marketing and advertising budget request of $200,856,000 for test year 1986. In Phase I, DRA recommended combined allowance of $89,623,000 for marketing and advertising based on disallowance of corporate advertising and a reduction of 50% of all other advertising. On the marketing side DRA established a range using the divested amount of marketing expense of $38 million for 1984 as the lower end and the actual $96.5 million marketing expense for 1984 as the upper end and then dividing the sum by two. By this calculation DRA would allow $67.230 million for marketing expenses.

In Phase I, TURN presented evidence critical of DRA being too favorable to the company, claiming that DRA began with the assumption of some validity of the company's requested 1986 figures, in the absence of any justification by the company. TURN believed that the company did not justify $22 million of advertising or for the $96 million of marketing expenses. TURN stated its preferred approach was to begin with the divested amounts for advertising of $11,010,000 and $38,000,000 for marketing, and escalate those figures by the media inflation level for advertising and the CPI for marketing. The resulting TURN recommendation for test year 1986 advertising expense allowance was $12,973,000 and for marketing was $41,060,000 for a total of $54,033,000. TURN also offered two alternatives using the 1984 staff's recommended level of $53 million adjusted for inflation to arrive at the first alternate of $58,734,000 and the Commission adopted 1984 level of $67,500,000 inflated to $79,533,000 using the media inflation factor and inflated to $72,937,000 using the CPI inflation factor, as additional alternatives.

In adopting a level for 1986 in D.86-11-079 at page 87 (mimeo.), the Commission stated that:

> "AT&T-C's request of $200.9 million represents more than a 200% increase over the $67.5 million awarded in our 1984 decision on a combined basis. This is obviously far more than the rate of inflation experienced during the intervening years. However, AT&T-C has never accepted the 1984 disallowances in this expense category (totaling $114.5 million) and has been spending in excess of the amounts authorized, thus opting to require its shareholders to absorb these excess amounts."

The Commission also expressed concern relative to the ratepayer benefit of this marketing and advertising activity stating:

> "AT&T-C has expended considerable effort in this case to explain the organizational structure of its marketing budget process, and the competitive environment of the 1986 marketplace in which it operates. It has provided substantially more information in this proceeding than it provided in 1984. However, sheer numbers of witnesses and copious amounts of information, while helpful and preferable to a paucity of information, do not automatically mean that an applicant has met its burden of proving that the amounts it requests are reasonable. This is especially true where disturbing questions exist about the magnitude of the level it requests in these expense categories. This question really goes to whether and how the levels of advertising and marketing AT&T-C proposes to pass on to California ratepayers actually benefit the latter..."
>
> * * *
>
> "One of the very real dilemmas we face is attempting to gauge how much California ratepayers should be required to pay to be persuaded to remain with AT&T-C in this equal access environment. We believe that we have a

responsibility to ensure that California ratepayers do not shoulder an inappropriate level of costs in order to allow AT&T-C to wage its all-out battle with the competition. We see no benefits to ratepayers in allowing this to happen by giving AT&T-C virtual carte blanche in this area. We must set some limits, given our established ratemaking policies on the commercial expense area, and their focus on a demonstration of ratepayer benefits. Therefore, we must reject AT&T-C's $200.9 million request, because we believe it is unreasonable to require California ratepayers to bear the costs of this excessive amount." (D.86-11-079, mimeo. pp. 87, 89.)

Following the above discussion the Commission made the following determination:

"For purposes of establishing a reasonable commercial expense, we will use the amount of $126,623,000. This amount consists of allowances of $22,393,000 for advertising and $104,230,000 for marketing, derived as follows:

"a. We use PSD's recommendation of $22.393 million for advertising, given the fact that it is based on PSD's review of AT&T-C's 1986 request, coupled with the application by PSD of this Commission's recognized ratemaking policies, to disallow institutional advertising. PSD's adjustment of 50% is appropriate given the fact that much of AT&T-C's advertising request does have the effect of institutional advertising. (See TURN Opening Brief, pp.36-38.)

"b. For the marketing component, we use as a starting point the $96.460 million actually spent by AT&T in 1984. We recognize that this amount is in excess of the amount authorized in 1984 (remembering that the $67.5 million is a combined figure for marketing and advertising), but we believe it provides a good starting point because presumably it represents a de facto sharing of these dollars between the ratepayers and shareholders.

"c. We adjust this $96.460 million starting point to account for the rate of inflation in intervening years; in accordance with TURN's recommendation in this case the adjustment is 4.3% CPI inflation for 1984 and 3.6% for 1985 (see Exhibit 122 footnote 1).

"d. Applying these adjustments, we arrive at a marketing expense allowance of $104,230,000 on a total California basis." (D.86-11-079, mimeo. p. 90.)

The advertising allowance is not an issue in Phase II. However, to place the overall amount on a comparable basis with the 1984 award for combined marketing and advertising of $5.00 per access line, the $126,623,000 represents over $8.90 per access line, assuming a 5% increase in the 13.5 million access lines from 1984 to 1986, for an assumed 14.2 million[12] access lines for 1986.

In D.87-04-041, we granted limited rehearing on the narrow issue of "...whether 1985 is a more appropriate year than 1984 to begin our determination of allowable marketing expenses for test year 1986." (supra.)

On this point DRA and TURN presented additional evidence to buttress the 1984 base (of $96,460,000) as the appropriate base year; on the basis of their studies, with increases for inflation, these parties maintain that the Commission in D.86-11-079 has

12 This 14.2 million assumed number of access lines for 1986 is based on the 13.5 million access line number used in D.84-06-111 increased by 5% and rounded up. This figure appears reasonable when compared with the total number of recorded end-of-year customers of all California local exchange telephone companies, as reported in their 1986 annual reports to this Commission. That total is 13,548,753.

already adopted a more than adequate marketing allowance of $104,230,000 for 1986.

DRA would not use the composite recorded 1985 amount of $138.9 million and merely allocate it to California; however, if the 1985 amount is used, DRA would make adjustments as described earlier, and arrive at a 1986 allocated and adjusted amount of $86.89 million as its recommended allowance for the test year. Of course, this result is a marketing allowance for the test year that is $17.34 million less than that already adopted in Phase I. (supra.)

AT&T-C's position remained that the 1985 recorded and unadjusted amount allocated to California of $138.9 million should be increased for inflation to $143.9 million and adopted as its marketing allowance for the test year. However, as DRA asserted in its brief, the use of 1985 marketing expenses without adjustment would reflect marketing expenses at their highest[13] in this three-year period [1984-1987] (Op. Br. 32 and Ex. 246, pp. 6-7).

As is evident from this background and from our Phase I decision, we have been uncomfortable all along with the record that has been developed on marketing expenses. Our decision that authorized the use of inflation-adjusted 1984 actual data was a compromise based on the lack of a complete and appropriate rationale from either TURN or from AT&T-C, the two parties whose showings we found most probative.

We would have preferred to utilize TURN's methodology exclusively, for its witness Therrien proved the most credible on this issue. Nevertheless, we were forced to find a more reasonable starting point for marketing expenses than was presented by TURN.

13 While AT&T-C's overall recorded 1986 marketing expenses were higher than in 1985, AT&T-C's marketing force counts began a decisively downward trend after reaching a plateau in mid-1986 (Ex. 246, p. 7 and Appendix C).

We are now faced with arguments in equity regarding the suitable base year. Ideally, we would have determined the reasonableness of a particular representative base year and then inflated it as Therrien suggested. However, the public policy and market structure upheavals that AT&T-C faced from 1984 to 1986 all influenced marketing expenses directly. We agree that 1984 was a start-up year for the new AT&T-C's marketing organization, but 1985 and 1986 featured extensive equal access marketing efforts that have in large measure since subsided. In reviewing the three years, no one stands out as representative of "business as usual".

We note that customers will choose the more attractive option when given a choice, and AT&T-C success at marketing could indicate a certain increase in customer satisfaction. Competitive responses to such efforts could benefit customers of all IECs.

In this light, we are still faced with the task of considering AT&T-C's 1984 and 1985 marketing expenditures and establishing a reasonable value for ratemaking. While we accept AT&T-C's characterization of 1984 as a start-up year, we also find merit in the contentions of DRA and TURN that equal access activities in 1985 rendered it as something of a peak for marketing expenditures (especially when noting the need for adopted 1986 values to serve for 1987 and 1988 as well). One choice left open to us is to adopt AT&T-C's 1985 actual expenses along with the carrier selection adjustment proposed by DRA's Fok (as AT&T-C outlines at page 9 of its comments to the proposed decision).

While we find some merit in this compromise, we still believe that 1985 expenses were unrepresentatively high even with this adjustment. Instead, we will make an equitable choice to average 1984 (as a valley) and 1985 with Fok's carrier selection adjustment (as a peak) to determine the reasonable marketing expenses for AT&T-C for test year 1986. The adopted value (adjusted for inflation) is thus $51.1 million on an intrastate basis.

In adopting this recommendation we again affirm, as we stated in D.84-06-111 at page 96 (mimeo.) that:

> "The Commission does not consider ratios based on revenues appropriate for the purpose of establishing revenues, because, among other considerations, of the introduction of the circular reasoning aspect."

Also, in D.86-11-079 Ordering Paragraph 3 on page 229 (mimeo.) we directed that:

> "In future rate proceedings, if AT&T-C wishes California ratepayers to bear a share of allocated advertising and marketing expenses, it shall present a cost/benefit analysis in its direct showing, over the latest available 12-month recorded period, as well as its pro forma analysis of future commercial expenses."

This requirement continues to appear sound and reasonable with the proviso that the cost/benefit analysis should be developed to give attention to small, average, and large use customers. The use of a direct allocation and specific cost/benefit analysis should help to set aside the question of the reasonableness of revenues as a proper allocation factor which we have previously questioned.

XI. Reporting Requirements

During the course of its audit, DRA repeatedly claimed that it had difficulties reconciling the costs and benefits of the functions, activities, sales, and return on investment associated with home office and affiliated transactions as charged to AT&T-C. DRA also had concerns regarding the actual in-service dates for the various billing and collection program functions and the beginning and ending dates for various corporate reorganizations.

Many of DRA's concerns were related to allegedly incomplete data responses and/or lack of specificity in the accounting records provided to DRA for auditing purposes.

Considerable time was used both on and off the formal record in an attempt to reconcile differences between AT&T-C and DRA relative to the information DRA needed to present its evidentiary showing.

By addressing the specific issues raised by DRA as we have throughout its order, it may be possible for AT&T-C to plan and use better record-keeping and provide certain periodic reports to DRA to assist it, in a more orderly and less cumbersome analysis for any future rate proceeding, or investigation, before this Commission.

As we recap, in Appendix D to this order, the reporting requirements that we have adopted, we are mindful of AT&T-C's views and arguments that we not overburden it with the retention and presentation of voluminous data not ordinarily developed, maintained, or required in the ordinary course of its business, and especially that of its non-utility affiliated operations.

Therefore, in Appendix D, we will limit the scope of periodic reports and emphasize necessary memorandum record-keeping to allow AT&T-C to present the data needed by DRA in connection with any future rate proceeding.

XII. Overcollections by AT&T-C

1. Background and Responses to ALJ's Request for Comments

Ordering Paragraph 18 of D.86-11-079 directed that the rates established by that decision, "...will be collected subject to refund, until a final decision is rendered in this 1986 test year proceeding.". Thereafter, by various other decisions this Commission has ordered reductions in access charges and other expenses which have reduced AT&T-C's costs of operations. The savings from these reduced costs of operations have not been reflected in rates and thus result in accumulated overcollections of $163.6 million[14] annually over existing rate levels until AT&T-C's rates are reduced to reflect current expenses. (AT&T-C's May 31, 1988 response to ALJ's request regarding refunds.) In addition, another $21.5 million has been accrued by AT&T-C from miscellaneous expense reductions.

Lastly, since the interim rates established by D.86-11-079 were made subject to refund pending this Phase II order, AT&T-C will be required to refund to its ratepayers an additional $6.6 million as of July 1, 1988 due to the final disposition of this proceeding (A.85-11-029).

The total amount available for refund as of July 1, 1988 is approximately $109.9 million based on the data noted above.

To prevent further accrual of overcollections by AT&T-C, rates must be reduced to bring them in line with current costs. This can be done by reducing current rates by $168.0 million annually.[15]

The assigned ALJ asked the parties to specifically address their comments or concerns regarding his proposed order to reduce rates to a current cost basis and to refund overcollections effective July 1, 1988, and whether these directives fulfill the requirements of PU Code § 453.5. He also directed the parties' attention to Kenneth Cory v Public Utilities Commission et al. (1983) 33 C 3rd 527, wherein the California Supreme Court cited its earlier opinion in California Mfrs. Assn. v Public Utilities Commission (1979) 24 Cal. 3rd 836, for review in preparing their comments.

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14 The accumulated overcollections at July 1, 1988 would be 1/2 this amount or $81.8 million.

15 $163.6 million annual reductions for D.87-12-067, D.87-12-070, D.87-12-051, D.87-10-088, and D.88-10-061, and $4.4 million for revenue requirement reductions adopted herein.

2. <u>AT&T-C's Position</u>

AT&T-C filed a separate detailed response to the ALJ's specific request. In its response AT&T-C stated that its refund plan should not be delayed until the final resolution of this rate case. AT&T-C then called attention to the fact that on May 20, 1988 it filed Advice Letter 97 seeking authority to reduce its current rates effective July 1, 1988 in order to flow through all past expense reductions heretofore ordered in the following five decisions:

o D.87-12-067	Pacific Bell	O.P. 35 & 38
o D.87-12-070	GTE California	O.P. 1 & 2
o D.87-12-051	Pacific Bell	O.P. 3
o D.87-10-088	ULTS (Tracking)	O.P. 2
o D.88-01-061	Tax Reduction Act	O.P. 1A

AT&T in its comments opined that if it must defer all refunding until final resolution of this rate case, it could not meet the July 1, 1988 proposed target date. Therefore, AT&T-C asks that its Advice letter 97 be approved expeditiously and that any additional rate adjustments which may arise from this proceeding be considered and implemented by a surcharge following the issuance of a final order in this proceeding (AT&T-C Comments, p. 2).

A careful review of AT&T-C's Advice Letter 97, appended to its comments, reveals that its proposal would substantially reduce its intrastate toll rates for the six-month period July 1 through December 31, 1988. It would also apply a modest surcredit to its private line services for the same period. The rate impacts of Advice Letter 97 (if adopted) would be approximately as follows:

- Reduction/Surcredit for <u>July 1988 only</u> with an effective rate reduction of 44% on Switched Services, and a Surcredit of approximately 3% on Private Line, and a

- Reduction/Surcredit for August 1, 1988 to December 31, 1988 with a rate reduction of 23% on Switched Services, and a Surcredit of approximately 3% on Private Line.

These impacts do not include effects of this Phase II decision in A.85-11-029. The change would be nominal in any case (2% or less).

The benefits of AT&T-C's Advice Letter 97 rate reductions would be entirely prospective and apply to message toll and private line services rendered from July 1, 1988 through December 31, 1988.

AT&T-C believes that its Advice Letter 97 fulfills the requirements of PU Code § 453.5 and is consistent with decisions of the California Supreme Court. AT&T-C comments that:

> "Section 453.5 provides that 'Whenever the commission orders rate refunds to be distributed, the commission shall require public utilities to pay refunds to all current utility customers, and, <u>when practicable</u>, to prior customers, on an equitable pro rata basis...' (emphasis added).
>
> "AT&T's intended distribution to all <u>current</u> customers (residential as well as business) is consistent with this Section. Indeed, any required distribution to <u>prior</u> customers, residence or business, as far back as March, 1986, would be cost-prohibitive and, in many instances, simply impossible. Since commencing business on January 1, 1984, virtually all the message toll billing for AT&T's intrastate interLATA services in California has been performed by the state's 24 local exchange companies; the records and data associated with this billing function are neither maintained nor controlled by AT&T. To require these 24 local exchange companies to identify and analyze the usage of all AT&T customers over the past two years in order to calculate refunds based on that prior usage would require an enormous work effort and would cost AT&T, and ultimately its ratepayers, nearly as much as the refund itself." (AT&T-C Response to ALJ Request, pp. 3 and 4.)

AT&T-C also estimated that the task of reviewing customer bills back to March 1986 and a separate calculation of each interLATA toll charge together with the preparation of refund checks to each prior customer would involve about three million man-hours of effort at a cost of more than $90 million.

AT&T-C contends that: "As a practical matter, the work force needed to complete this job in a reasonable period of time simply does not exist."

AT&T-C also comments that:

- o Many of the LECs do not maintain billing records for longer than 90 days.

- o Pacific Bell and General Telephone Company of California (General) were specifically excused by the Commission in D.91337, pp. 44-45 from refunding to any prior residential customers--on the basis that it would be extremely costly, time consuming, and unsuccessful.

- o The Commission determined that a strict retroactive refunding requirement on the part of General--even with respect to its business customers would be impracticable and therefore not required under PU Code § 453.5.

- o Attempting to identify and track the prior toll usage of AT&T-C's long distance customers during the period of "inter-exchange carrier selection" adds a refund complexity never before addressed by this Commission.

AT&T-C then cited four other advice letters that it filed with this Commission to distribute overcollections to current customers based on current [prospective] usage; these were:

- o Advice Letter 30, effective October 29, 1984,
- o Advice Letter 66, effective September 1, 1986,
- o Advice Letter 83, effective July 1, 1987, and
- o Advice Letter 90, effective January 1, 1988.

Lastly, AT&T-C stresses that its proposed "...refund plan is also consistent with the California Manufacturers' decision." [California Manufacturers Association v PUC (1979) 24 Cal. 3d 836.]

In that case, according to AT&T-C, the California Supreme Court held that the Commission had exceeded its authority when it "distributed" supplier rebates to utility balancing accounts (as an offset against prospective rate increases), rather than refunding in accordance with PU Code § 453.5. The Court was not asked under those circumstances whether retroactive refunding was either cost-prohibitive or practical. AT&T-C also called attention to the Court's instructions to the Commission relative to refunds and then summarized its position for this proceeding as follows:

> "The Court further stated that in formulating a refund plan, the Commission should be, '...mindful of section 453.5's admonition that the obligation to provide pro rata refunds based on past usage is limited by considerations of practicality.' (Id. at 848.) The Court further instructed that '...where a statute is theoretically capable of more than one construction, [the Court] will choose that which most comports with the intent of the Legislature...'" (Id. at 844.)
>
> "Accordingly, the Commission has full authority, within the requirements of Section 453.5, to consider the complex circumstances and practical limitations in connection with AT&T's proposed refund. AT&T's plan -- which will refund all prior expense savings to present customers on the basis of current usage -- is both reasonable and practicable; it is consistent with the decisions of the California Supreme Court; and will fulfill the basic underlying requirement of Section 453.5 that all such refund distributions must be made on an 'equitable pro-rata basis.'" (AT&T-C Response to ALJ Request, pp. 9 and 10.)

AT&T-C in its Late-Filed Reply comments dated June 8, 1988 responded to other parties' charges that its Advice Letter 97 would set predatory and anticompetitive rates as follows:

> "U.S. Sprint, MCI, CALTEL, and DRA argue that AT&T's plan to distribute the Commission's previously ordered expense reductions to current customers based on current usage is anticompetitive and violates Section 453.5 of

the Public Utilities Act. The protestants are wrong on both counts.

"First -- with respect to the potential competitive impact of AT&T's planned refund - it is critical to remember that the access charge reductions and tax savings which constitute the primary bases for these refunds have been enjoyed proportionally by all interexchange companies (IECs), including MCI and U.S. Sprint. The Commission's SPF to SLU access charge reduction plan clearly anticipates that all resulting expense savings realized by IECs will be passed along to their customers in interexchange rate reductions, thereby reducing the potential for uneconomic bypass of the local exchange network.

"Although both MCI and Sprint have expressed concern over the manner in which AT&T proposes to refund its expense savings, both companies have had -- and will continue to have -- the same opportunity as AT&T to pass these access charge reductions and tax savings along to their customers..." (AT&T-C June 8, 1988 Reply Comments, p. 5.)

3. Other Parties' Positions on ALJ's Proposed Refund Plan

DRA, CALTEL, MCI, TURN, and U.S. Sprint all filed comments regarding the proposed refund plan and all were opposed to the method recommended by AT&T-C in Advice Letter 97.

a. DRA Comments on Refunds

Referring to Cory v PUC, DRA contends that:

"The Cory decision specifies that the statutory formula contained in Public Utilities Code Section 453.5 must be used to distribute refunds. Under Cory, present customers must be compensated on the basis of prior usage to which the refund corresponds, and, where practical, prior customers must also participate to the extent of the overcharges which they previously paid.

"AT&T-C's May 20th Advice Letter No. 97 proposed to refund in two steps. First,

> rate reductions ordered prior to January 1, 1988 will be accomplished by a negative surcharge for the month of July, 1988. Second, rates will be reduced for a period of six months from July 1 - Dec. 31, 1988 to reflect 1988 access charge reductions.
>
> AT&T-C proposes to reduce rates of present customers regardless of present or past usage and regardless of whether a present customer was a customer for the period in which refunds apply. This is not a refund plan, it is a proposal to reduce rates in lieu of refunds and clearly violates the Cory decision.
>
> "This proposed refund plan would invite customers of interLATA competitors to switch to AT&T-C to obtain rate reductions of approximately 40% for a period of six months. Such Commission-approved tampering with the interLATA market to the benefit of AT&T-C is untenable." (DRA May 31, 1988 Comments, pp. 1 and 2.)

DRA then stated that it will request that Advice Letter 97 be suspended pending the issuance of a final decision in this proceeding. On June 8, 1988 DRA filed its request to Suspend Advice Letter 97.

On June 8, 1988 DRA as a part of its "Late-Filed Reply Comments" recommended that the Commission use, "...the existing 90 days usage data available to AT&T-C with weighting factors to compensate for the exact period within which refunds were due.", for computing one-time refunds. In addition, DRA recommended that approximately one-tenth of the amount be reserved for prior customers who may have left the company. DRA also recommends that public notice of ordered refunds be required; such notice would state "...when, where and how a prior customer could claim, prove and receive any refund to which he/she is entitled." (DRA June 8, 1988, Late-Filed Comments, p. 7.)

b. <u>CALTEL Comments on Refunds</u>

In its filed comments, CALTEL recommended that the advice letter filed pursuant to the revenue requirement determination in this proceeding "...only reflect [AT&T-C's] post-July 1988 revenue requirement." Any overcollection occurring prior to that date should be refunded pursuant to the Refund Plan filed pursuant to this order. "That Refund Plan, in turn, should provide for direct refunds to existing customers (and, where practical, prior customers) based on those customers' usage during the period March 1986 - to the effective date of the rates implemented..." in this proceeding. (CALTEL May 31, 1988 Comments, p. 2.)

CALTEL also directs attention to the fact that many of the IECs as "pure" resellers were permitted, in the past, to use lower cost exchange facilities for originating access rather than being required to use more expensive feature group facilities from the LECs. By D.85-06-115 and Federal Communications Commission (FCC) Docket 86-1, this Commission and the FCC began to require all IECs to purchase originating access services out of the LEC's access tariffs and to not receive any credits reflecting WATS usage. As a result many IECs that employed WATS during 1986 and 1987 are no longer users of WATS or any other service from AT&T. "These IECs cannot, therefore, receive any refunds distributed as future reductions."

CALTEL stresses that:

> "The IEC WATS customers of AT&T stand in the same shoes as the large natural gas users described in <u>California Manufacturer's Association v. Public Utilities Commission</u> (1979) 24 CAL 3d 386, 157 Cal. Rptr. 676. Those natural gas users had paid overcharges during particular years and then substantially left the gas system prior to the period that the benefits of supplier refunds, which were to be passed into future rates through adjustments to a balancing account, would be placed into effect. The CMA holding is described in <u>Kenneth Cory v. Public Utilities Commission</u> (1983) 33 Cal. 3d 522, 189 Cal. Rptr. 386."

c. MCI Comments on Refunds

In its comments MCI urged the Commission adopt a one-time refund which in its view is required by PU Code § 453.5. MCI contends that in addition, "The statute, as interpreted by the courts, expresses a strong public policy favoring the distribution of refunds back to the same customers who paid the revenues to the utility in the first place. In fact, the statutory allocation of refunds requires that current customers must be compensated on the basis of their prior usage." (MCI May 31, 1988 Comments, p. 2.)

MCI also urges the Commission to take care, "...that the prices which utilities charge reflect current costs, and thus send the proper price signals to customers. If it does otherwise, consumption and investment decisions will be skewed inappropriately, and AT&T would be granted an artificial market advantage." (MCI May 31, 1988 Comments, p. 3.)

MCI summarized its May 31, 1988 comments on refunds as follows:

> "No one should be heard to complain if [AT&T-C's] prices reflect current costs, including access, other internal costs and a reasonable return. But a six month refund plan, for example, could easily result in prices for that period of time which would fall well below those costs. Under those circumstances the Commission would be sanctioning unlawful, predatory pricing, and would assure that AT&T's competitors would be unprofitable for that period of time. Such a result may well be consistent with AT&T's shareholders best interests, but it would not serve the public interest. The Commission should take care that no refund plan permit [AT&T-C] to design rates which would fall below [AT&T-C's] then-current costs." (MCI May 31, 1988 Comments, p. 4.)

On June 8, 1988, MCI submitted Late-Filed Reply Comments which buttressed its position in opposition to prospective rate reductions in lieu of one-time refunds, and provided additional support for the comments earlier submitted by DRA and U.S. Sprint discussed herein.

d. <u>U.S. Sprint Comments on Refunds</u>

U.S. Sprint opined that the Commission's careful evaluation of the filed comments is crucial, because the way the refund process is structured and implemented could affect the state of competition in the IEC industry for some time in the future.

U.S. Sprint detailed its support for a one-time refund instead of the AT&T-C's prospective rate adjustment contained in Advice Letter 97. U.S. Sprint contends that in that advice letter AT&T-C proposes six months of rate decreases for only current customers in lieu of a refund. "This type of proposal is anticompetitive and predatory. The Commission should reject AT&T's proposal because it proposes below cost predatory pricing which will negatively affect competition during a crucial transitional phase; it attempts to lock in customers by offering below cost rates for a sustained period which are cross-subsidized from above cost rates offered during an earlier period; and it discriminates between customers by failing to distribute any refund to former customers. (U.S. Sprint May 31, 1988 Comments, p. 2.)

U.S. Sprint asserts that AT&T-C's Advice Letter 97:

> "...forces current customers to remain with AT&T during a six month period to obtain the full refund due the customer."
>
> * * *
>
> "What AT&T really is doing, in trying to win the game, is requesting that the Commission allow it to offer below cost prices to its current customers in the last half of the year, with those rates cross-subsidized by the over-cost prices of the first half of the year. Not only is this type of refund unfair, because customers owed refunds will not receive them, but it is illegal.
>
> "AT&T should be ordered to refund the money to customers owed it, both current and

previous, on a one time lump sum basis. To deny refunds to previous customers constitutes rate discrimination between classes of customers in violation of Section 453.5 of the California Public Utilities Code which indicates, in relevant part, that

> 'Whenever the commission orders rate refunds to be distributed, the commission shall require public utilities to pay refunds to all current utility customers, and when practicable to prior customers, on an equitable, pro rata basis...in proportion to the amount originally paid for the utility service involved, or in proportion to the amount of such utility service actually received.'

"Those customers who purchased AT&T services in early 1988 but now are purchasing services from other carriers will pay more for the early 1988 AT&T services than customers who remain with AT&T. This form of rate discrimination is very invidious, because it is designed to impose exit penalties on customers who switch to other carriers. This anticompetitive rate discrimination should not be permitted by this Commission." (U.S. Sprint May 31, 1988 Comments, pp. 3 and 4.)

U.S. Sprint summarized its comments stating that the refund not be tied to current customers' prospective rates because the adjustment of prospective rates for accomplishing a refund has,

> "...the strong potential to discriminate against some classes of customers, allows predatory below cost pricing subsidized by earlier above costs rates, and permits AT&T to 'lock-in' customers during a crucial transition period in the interexchange industry. For all practical purposes, the Commission needs to play its public interest role as a referee, and call 'foul' to AT&T's game plan. The Commission is entrusted with and empowered to create the rules of this game. U.S. Sprint

respectfully requests that the Commission makes sure that the rules are fair, that AT&T plays by them, and that all players have the opportunity to compete." (U.S. Sprint May 31, 1988 Comments, pp. 6 and 7.)

In its Late-Filed Reply Comments U.S. Sprint stressed that AT&T-C has not demonstrated why it should be allowed to distribute the money that lawfully belongs to former large customers to its current customers. U.S. Sprint then requested that AT&T-C's Advice Letter 97 and "...its ill-advised proposal be rejected," and that the Commission require that any refund plan be adequately supported by relevant data and comments by other parties to this proceeding.

e. TURN Comments on Refunds

TURN by its May 31, 1988 "Comments" recommended a one-time refund of the overcollections and then chided AT&T-C as follows:

"The ALJ's recommendation that a one time refund of 'approximately $116 million' be made to [AT&T-C's] customers to flow through results of access charges, Universal Life Line Telephone Service, and Tax Reform Act of 1986 overcollections as well as amounts collected subject to D.86-11-079, should be adopted forthwith. It is not surprising that, separately [AT&T-C] filed an advice letter subsequent to the issuance of this proposed decision that calls for a different distribution. AT&T doesn't give up easily. Neither do consumers." (TURN May 31, 1988 comments, p. 1.)

4. <u>Discussion</u>

The question of how to convey the monies that have accrued in AT&T-C rate overcollections is a complicated one that requires careful consideration. We are, on the one hand, faced with a substantial memorandum account and a utility (AT&T) willing to distribute it to ratepayers via an immediate rate reduction. Alternatively, competitors and certain customers urge us to offer lump-sum refunds and leave rates more or less at current levels. We have labored diligently to assess the reasonableness of expenditures whose disallowance again lowers competitive rates. Certain parties have argued both for refunds (which would keep rates higher) and for disallowances (which would lower rates).

We did not expect such difficulties when we decided to consolidate a series of access charge reduction flow-throughs into one rate adjustment. Rather than ordering immediate AT&T-C rate adjustments for each change in local exchange access charges, we ordered that a memorandum account be kept, with interest, to be reflected in AT&T-C's rates upon our order. We did this to minimize customer confusion regarding frequent rate adjustments and to minimize the administrative costs to all concerned (regulators, customers, and AT&T-C). We anticipated that this memorandum account might contain increases as well as decreases, depending upon the outcomes of the various local exchange decisions upon which the access charge changes would be based; indeed, we refrained from labeling this a balancing account solely to minimize the accounting and financial reporting issues that such a designation would raise. We also expected this account to be eliminated expeditiously, and today's action does so.

Over a period of months these monies have accumulated rapidly. The question now is whether to depart from our original intention to reflect these access charge cost reductions in rates on a going-forward basis, or whether to accept any of the arguments presented in favor of an alternative treatment.

We should first note that we have carefully reviewed the legal issues raised by the cases of California Manufacturer's Association v. Public Utilities Commission (1979) 24 Cal. 3d 836 and Cory v. Public Utilities Commission (1983) 33 Cal. 3d 522, and we do not find them constraining upon our ability to proceed with a wholly prospective rate adjustment for AT&T-C. Specifically, the California Manufacturer's Association case (from which Cory follows) involved supplier rebates returned to the utility for service delivered several years in the past. There are no supplier rebates here, nor do the access charge reductions date back longer than a matter of months.

AT&T-C's competitors argue for a retrospective refund, presumably with the intent of facing higher competitive long distance prices than would obtain with a prospective adjustment. The competitors assert that a prospective reduction would be anticompetitive.

However, we must note that all interexchange carriers have received the benefits of the access charge reductions; the amounts accrued in AT&T-C's memorandum account have been paralleled by proportionately similar access charge reductions received by all interexchange carriers. For some months we have kept AT&T-C's rates above the level that these reductions would have permitted; its competitors have presumably either passed through some of their savings in lower rates to attract customers, or retained their savings and kept rates close to AT&T-C's (in which case the accumulated savings will be available for competitive responses to an AT&T-C reduction). In either case, AT&T-C and its interexchange competitors will have been on an even footing in regards to their access charges and ability to maintain comparable rate levels for the entire period in question (excepting, of course, the competitors' own costs, which are their business). We are therefore satisfied that the competitive implications of a prospective rate adjustment are reasonable.

Certain large customers note that they might benefit more from a proportional refund granted on the basis of prior use rather than by a prospective rate reduction. Even if true, this argument is not persuasive given the brief time these rate reductions have been postponed. The arguments by the California Association of Long Distance Telephone Companies regarding the direct assignment of WATS by this Commission and the FCC raise the issue of customers that may have discontinued prior use of AT&T-C in part due to other regulatory decisions. However, the migration away from AT&T-C service is asserted to have occurred during 1986 and 1987, while the access charge reductions at issue here were added to the memorandum account in 1988. Had we not employed the memorandum account, the access charge reductions would have been passed into AT&T-C's rates after these customers had already left AT&T-C.

AT&T-C's position as an interexchange carrier that bills the majority of its customers through local exchange operating companies is another factor in this decision. Because these local exchanges do not retain AT&T-C billing records for more than 90 days, it is not practicable to require a refund to all customers based on earlier billing. AT&T-C's comments make this fact clear in estimating that three million man-hours might be required to make such refunds; while we are unsure as to the exact magnitude of the required effort, it is clear that such an effort could easily exhaust the balance of the memorandum account. We are not convinced that refunds based on immediate past usage (i.e., up to 90 days) have much to recommend them over a rate adjustment based on usage in the present and in the immediate future. Given the impractibility of going back more than 90 days, we would expect a going-forward rate adjustment to perform almost as well as a refund in matching prospective rate reductions to the savings those same customers would have received had we lowered AT&T-C's rates as each access charge adjustment occurred.

Finally, we are bound to ask whether the needs of customers are better served by a refund or by a substantial rate reduction. We have found before that a rate reduction will stimulate greater volumes of calling; these additional calls create benefits to consumers that they would not otherwise receive if rates were to remain near current levels. We believe that most customers will prefer to make more future calls at cheaper rates instead of receiving a one-time refund based on recent use.

Given our preference for a rate reduction, we must determine its specific form. AT&T-C's Advice Letter 97 proposes a special July surcharge in addition to a substantial rate reduction that would take effect for the remainder of the year. We see no reason to cut rates dramatically one month followed by a substantial increase the next; this would create some of the administrative cost and customer confusion we sought to avoid by consolidating the access charge pass-throughs into one rate adjustment. Instead, we will reject Advice Letter 97 and order AT&T-C to implement a uniform percentage reduction for switched services to be effective from July 1, 1988 until the end of the year. This reduction will include the effects of amortizing the memorandum account as well as the rate impacts associated with the findings in this decision. Specifically the effects of previously experienced expense reductions should be applied to produce a uniform six-month surcredit, while ongoing reductions in the authorized revenue requirement should be applied to reduce rates. For private line services, AT&T-C should use the approach followed in Advice Letter 97 to bring rates in line with costs.

<u>Findings of Fact</u>

1. Review of DRA's audit report was the main thrust of this proceeding; therefore, DRA made the initial presentation of all issues in the Phase II hearings and its position is routinely discussed first in this order; nonetheless, the burden of proof for the reasonableness of all expenses rests with AT&T-C under PU Code Section 454.

2. AT&T began a major corporate reorganization in 1986 which will affect nearly every part of its operations when it is fully implemented.

3. The basic reason for AT&T's reorganization, initiated in 1986, was to cut costs and improve the efficiency and competitive position of AT&T's overall operations.

4. AT&T's overall employee expenses were likely increased for test year 1986 due to AT&T's corporate reorganization.

5. Neither AT&T-C nor DRA furnished full details of the near term future benefits of the reorganization plan or the normalized and annualized present worth of those benefits for the test year.

6. DRA has identified modest specific expense savings due to employee reductions associated primarily with AT&T-C's marketing activities.

7. DRA determined the reorganization savings to be $3.5 million for test year 1986 and applied that amount to AT&T-C's total California marketing activities.

8. DRA did not reduce the $3.5 million proportionately for the adopted versus budgeted marketing allowance.

9. DRA's recommended $3.5 million reorganization adjustment should be proportionately reduced to apply to the authorized rather than budgeted marketing expenses for test year 1986. The resulting statewide reorganization expense adjustment to AT&T-C's marketing activities is $2.7 million, and on an intrastate basis is $1.2 million.

10. This proportional reduction of DRA's reorganization adjustment shares the benefit of reorganization cost savings between AT&T's customers and shareholders based on their separate contributions to the marketing budget as identified elsewhere in this order.

11. DRA's recommended test year 1986 disallowance and deferral of all expenses associated with the development and deployment of AT&T's customer service and billing program, excepting for account inquiry functions, is insupportable based on the record which demonstrated that certain other program functions were also used and useful in AT&T-C's California intrastate operations during all or part of 1986.

12. AT&T-C confirmed the taking back of certain intrastate customer billing functions through renegotiation of costs for such services previously performed by Pacific Bell and other LECs and passing through to its California intrastate operations $20.454 million in 1986 expense reductions, by a compliance filing on July 23, 1986 in Phase I of this proceeding.

13. Confusion reigned throughout this proceeding regarding which, if any, of the eight separate functions of AT&T's customer service and billing program were partially or fully operational for California intrastate operations during 1986, and DRA and AT&T-C were unable to resolve this issue during this proceeding.

14. Account inquiry, service order entry, account maintenance, and message investigation functions of the customer service and billing program were deployed to California in 1984 and at least partially used and useful in California during test year 1986 based on AT&T-C's late-filed Exhibit 250.

15. Message toll service (MTS) billing, MTS message processing, MTS credit and collection, and MTS remittance processing functions of the customer service and billing program will not be in service or used and useful in California until June 1988 or later.

16. The modest $5.7 million expense deferral for its customer service and billing program urged in AT&T-C's closing brief was not supported effectively by a record which demonstrates that the LECs still perform significant amounts of work and incur large expenses for billing and collection functions.

17. The $9.1 million deferral in an interest-bearing account (as computed by DRA at the ALJ's request of used and useful customer service and billing functions performed by AT&T-C in test year 1986) sets a compromise between DRA's record position that $20.1 million be disallowed recognizing that only the account inquiry function was in place, and AT&T-C's request for full recovery of its development and deployment of a separate customer service and billing system in test year 1986. This deferral also recognizes the need to preclude cost duplication for work concurrently performed by the LECs.

18. I.88-01-007 is the appropriate forum for determining the reasonableness of AT&T-C's plan and costs to directly bill its customers for interstate and interLATA message toll service.

19. Interest accrual on the deferred account at the average three-month commercial paper rate, as published in the Federal Reserve Bulletin, will offset AT&T-C's loss of productive use of its funds expended in developing its customer service and billing system, until the system is fully used and useful in and non-duplicative of other similar services currently used by AT&T-C in California.

20. The remaining intrastate expense level previously adopted on an interim basis for AT&T-C's billing and collection in D.86-11-079, for functions not yet used and useful, after exclusion of the $9.1 million in the amount of $166,981,000 for test year 1986, is reasonable.

21. While AT&T's overall corporate headquarters organization has changed significantly, with substantial headquarters staff reductions in the post-divestiture structure, specific corporate

headquarters functions continue to be predominantly investor-related.

22. The overall advertising budget for AT&T-C's test year 1986 was adopted in Phase I of this proceeding and no further consideration of AT&T-C or AT&T-CH advertising issues is necessary or appropriate in this Phase II decision.

23. AT&T-C has advanced arguments worthy of our consideration regarding the need for, and ratepayer benefits of, public relations and employee information functions and activities at and after divestiture and more specifically during the period of interexchange carrier of choice selection by the public.

24. Allowances herein, for corporate and field public relations expenses for public and employee information, education, and awareness are unique to the needs associated with divestiture reorganization and interexchange carrier selection periods.

25. Public relations expenses for functions including sponsorship of media events and cultural activities, charitable activities, and corporate image enhancement are clearly investor-related functions and it is this Commission's long-standing policy to not burden ratepayers with such costs.

26. DRA auditors' recommended partial disallowances of AT&T-CH expenses for identifiable investor-related legal department and corporate finance and accounting functions, as further described by AT&T-C witness Ankiel, appear reasonable and should be adopted.

27. AT&T-CH's Corporate Strategy and Development functions, as further described by AT&T-C's witness Ankiel, are clearly investor-related and have routinely been disallowed in the past by this Commission. There was no new evidence in this proceeding which would warrant a different treatment of these expenses for AT&T-C in test year 1986.

28. DRA's recommended equal-to-all lines of business allocation method does have merit when allocating the expenses for

specific services that are of equal benefit to all affiliated or subsidiary companies.

29. The use of DRA's proposed equal-to-all lines of business allocations method should be developed further in cooperation with other regulatory agencies across the nation, and then presented again as and if appropriate in future AT&T-C general rate proceedings.

30. D.87-12-063 has exempted AT&T-C from the need to reestablish and maintain an Account 674 for affiliate company transactions. However, AT&T-C is required by the same order to maintain its "affiliate company costs on a side record basis." (D.87-12-063, mimeo. p. 48.)

31. D.86-11-079 for Phase I of this proceeding left the record open to receive DRA's audit report, and for AT&T-C to fully develop the record before we decide the issue of which, and what level of AT&T-CH and NOMC allocated public relations expenses are reasonable for ratemaking purposes in test year 1986 for AT&T-C's California intrastate operations.

32. AT&T Communications, Inc. (NOMC) did not maintain its books and accounting records on a basis wherein activities and projects could be specifically identified and accounted for during test year 1986.

33. Because NOMC accounting records were not maintained on a project or activity basis, DRA auditors utilized an alternative to their traditional auditing method, which involved meetings with department representatives of each NOMC department and review of examples of departmental outputs.

34. While dissatisfied with lack of project tracking and record-keeping, DRA did not make disallowances for the finance, legal, and personnel functions of NOMC, or the operator services allocated to NOMC's Network function from AT&T-CH.

35. Public relations functions which were directed at providing timely, accurate, and consistent information to the

public at or shortly after divestiture and at the time of interexchange carrier selection were beneficial to AT&T-C's ratepayers.

36. Public relations expenses for functions directed at improvement of employee morale at the time of reorganization after divestiture were beneficial to ratepayers.

37. Divestiture brought about major corporate organizational changes for AT&T, and a one-time allowance to share the public relations functional expenses between investors and ratepayers, during this period of major reorganization, should be given serious consideration.

38. Public relations expenses for activities and functions that primarily improve corporate image and/or benefit AT&T's investors should continue to be disallowed for ratemaking purposes.

39. Access charges are collected by AT&T Communications companies in message toll rates and then are passed on to the LECs. Therefore, there is no more logic to including access charges in revenues and expenses for allocation purposes than to include taxes in these factors.

40. The elimination of one of the three factors entirely because it (revenue factor) improperly included access charges, and failure to replace it with a more reasonable factor, causes an improper allocation result.

41. The 1985 usage factor is comparable to the 1986 revenue factor and was used as a preferable substitute for the revenue factor excluding access charges in this decision.

42. The usage factor more accurately allocates costs based on use activity in any given AT&T Communications subsidiary IEC, since usage is independent of rates which are set at different levels by each regulatory agency.

43. In applying the 1985 switched usage factor, private line usage impact was inadvertently excluded, therefore it is necessary to include the private line revenues of 9.2% as suggested by AT&T-C

to further adjust (increase) NOMC allocated expenses to AT&T-C's California intrastate operations by $100,000 rounded. However, this finding should not be construed to mean that we have in any way softened on our position that revenues are not an appropriate factor for allocations of out-of-state expenses.

44. The fact that AT&T had retained nearly 89% of the 1983 gain on sale of its 195 Broadway building and land was first discovered during DRA's 1986 audit of AT&T's operations.

45. American in 1983 passed on to the then Bell System Operating Companies $10.4 million, representing approximately 11% of the after taxes gain on the July 1, 1983 sale of its 195 Broadway headquarters building, including interest. The balance of the gain and interest was then remitted to the AT&T Foundation, a charitable trust.

46. Neither AT&T-C's 50% nor DRA's 100% suggested pass-through of the remaining gain on sale is reasonable, based on their widely diverse simplistic review of license contract allowances by this Commission over the years.

47. An adjustment of $2,000,000 equal to about 75% of the amount of gain computed by DRA to be allocated to AT&T-C's California intrastate operations reasonably and adequately represents the ratepayer contributions to PT&T's license contract payments from 1918 through 1983.

48. A memorandum account adjustment to rate base will assure that any resulting revenue reduction will be prospective only and will not affect prior earnings of AT&T-C.

49. Any requirement for a future allocation of this adjustment for gain on sale of the 195 Broadway building to Pacific Bell for it, or its predecessor PT&T, as suggested by AT&T-C, is clearly inappropriate since neither of these entities ever obtained productive receipt of any portion of nearly 89% of the remaining gain on this transaction.

50. The Western Electric adjustment for the predivestiture assets of PT&T which were segregated to AT&T-C should be amortized over an 11-year period to moderate the impact of this adjustment on AT&T-C's earnings and spread this ratepayer benefit over 11 years.

51. The 11-year amortization of the Western Electric adjustment on AT&T-C's assets received from PT&T on January 1, 1984 will result in a net revenue reduction of $738,000 and a .20% reduction on the rate of return for AT&T-C's intrastate operations.

52. AT&T-C's reporting of its annual construction budget, its purchases from Technologies which are expensed and capitalized, and the capital structure of Technologies will assist DRA in determining whether such transactions are significant enough to warrant further review of Technologies earnings in the future.

53. Reasonable detail in the record-keeping by Technologies will assist in future DRA review of the reasonableness of Technologies' transactions with AT&T-C.

54. The work performed by American Transtech in servicing securities and providing other investor-related services for AT&T, on an affiliated basis, is not as risky as AT&T's manufacturing or telephone utility operations.

55. AT&T-C has not presented persuasive evidence to show that the services it receives from American Transtech should be priced to derive a greater rate of return than that authorized for its telephone operations.

56. While American Transtech has reduced its charges to AT&T for services rendered in 1986, the adopted test year estimates in AT&T-C's last general rate decision, D.86-11-079, were based on the expense estimates for calendar year 1985 and therefore still require adjustment from the prereduction level.

57. DRA's recommended audit adjustment of $100,000 annually to the charges incurred by AT&T-C on its intrastate operations for the investor-related and other services provided by American Transtech is reasonable.

58. The 50% predivestiture adjustment of Bell Labs' expenses because of its 50% ownership by Western Electric is no longer appropriate, since Technologies, the successor to Western Electric, has no ownership control of Bell Labs.

59. In Phase I of this proceeding TURN raised serious concerns whether the results of R&D effort would be used and useful to AT&T-C's customers in the near future. These concerns were not adequately addressed in the evidence submitted in Phase II.

60. Neither DRA nor AT&T-C provided evidence to show that Technologies will not receive a disproportionately greater benefit from Bell Labs' R&D efforts than will AT&T's telecommunications utilities.

61. While the risks associated with failing R&D projects were discussed with reasonable accuracy on the record, the real business risk of Bell Labs, whose AT&T funding is based on contributions from affiliated companies, was not addressed in a well-defined or comprehensive manner.

62. From the overall record before us, it appears that AT&T-C's own business risk as a provider of interLATA and interstate telecommunications is greater, due to a modest amount of competition from other interexchange carriers, than that of Bell Labs on R&D performed for AT&T's communications companies.

63. It is reasonable to require AT&T-C to demonstrate on a program-by-program basis the potential near term benefits to its California customers of Bell Labs' R&D activities in future rate proceedings, prior to adopting such expenses for any new test period.

64. The concerns raised by TURN in Phase I of this proceeding relative to the near term usefulness of Bell Labs' ongoing R&D efforts were not resolved by the evidence presented in Phase II of this proceeding.

65. The $300,000 adjustment in the allocated intrastate expenses to AT&T-C for Bell Labs' R&D efforts is the minimum

reasonable disallowance for such expenses and only serves to bring rate of return parity to Bell Labs with that of AT&T-C.

66. D.86-11-079 authorized a combined advertising and marketing budget of $126,623,000 of which $22,393,000 was allocated to advertising and $104,230,000 to marketing functions for test year 1986.

67. The combined advertising and marketing allowance of $126,623,000 represents $8.90 for each of the state's total estimated 14.2 million access lines, and this should be compared with the last authorized advertising and marketing allowance of $67.5 million which amounted to $5 for each of the estimated 13.5 million access lines in California for test year 1984.

68. D.86-11-079 adopted the amount of $22,393,000 for test year advertising functions, and no further issues were raised in Phase II relative to AT&T-C's test year 1986 advertising budget.

69. D.87-04-041 granted limited rehearing on the marketing issue to allow AT&T-C to present argument as to whether 1985 was more appropriate than 1984 to begin determination of allowable marketing expenses for test year 1986.

70. It is reasonable for AT&T-C to spend modest amounts of its marketing budget to keep its customers informed about rate changes and new service options that may become available from time to time.

71. There is no evidence in the Phase II record that any telecommunications service rendered by AT&T or AT&T-C is poor; if anything, there were numerous comments and/or opinions of good service by AT&T and AT&T-C.

72. Due to the start-up activities that were necessitated by divestiture, AT&T-C's marketing expenses during 1984 were unrepresentatively low for purposes of setting 1986 test year marketing expenses.

73. Even with an adjustment for the level of equal access activity undertaken that year, AT&T-C's marketing expenses during

1985 were unrepresentatively high for purposes of setting 1986 test year marketing expenses.

74. An equitable level of marketing expenses for test year 1986 can be established by averaging AT&T-C's actual marketing expenses for 1984 and its marketing expenses for 1985 as adjusted by DRA for carrier selection activities; on an intrastate basis adjusted for inflation, the proper value is $51.1 million.

75. AT&T-C's marketing efforts have the potential to improve the satisfaction of its customers directly and the satisfaction of its competitors' customers indirectly through competitive forces in the interexchange market.

76. In D.87-12-070 on December 22, 1987, the Commission ordered AT&T-C to consolidate a series of subsequent changes in the access charges that AT&T-C pays to local exchange companies into a memorandum account with interest for later reflection in AT&T-C's rates in order to minimize administrative costs and customer confusion due to frequent and potentially offsetting AT&T-C rate changes.

77. The local exchange access charge reductions that were consolidated into the memorandum account occurred as a result of Commission orders in D.87-12-070 (December 22, 1987), D.87-12-051 (December 22, 1987), D.87-12-067 (December 22, 1987), and D.88-01-061 (January 28, 1988).

78. A balance began to accrue in AT&T-C's memorandum account on January 1, 1988.

79. All interexchange telephone companies purchasing local exchange access have received proportionately similar access charge reductions from local exchange companies regulated by this Commission.

80. As previously discussed, because AT&T-C's competitors have received similar reductions in the access charges they pay, a prospective AT&T-C rate adjustment to reflect these access charge

reductions will not competitively disadvantage other interexchange carriers.

81. It is not practicable to refund the balance in AT&T-C's access charge reduction memorandum account based on customer usage dating back more than 90 days from the present due to the prohibitive costs that would be incurred in retrieving billing information from the local exchange companies that render customer bills for AT&T-C.

82. Because it is not practicable to base refunds on more than the last 90 days of customer usage, we cannot match refunds to exact customer usage during the period of the memorandum account.

83. The process of granting refunds based on the previous 90 days of customer usage would involve substantial administrative costs as outlined in AT&T-C's response to CACD's data request 88-04-08C; the cost for Pacific Bell would be $1.6 million, while undetermined other costs would be expended by other local exchange companies that bill for AT&T-C.

84. The possibly greater precision of providing refunds to customers based on recent usage within 90 days is not a compelling reason for undertaking such refunds when the alternative is rate reductions based on usage during the next six months.

85. A prospective AT&T-C rate reduction will enable customers to make many more calls in response to lower rates. This benefit is substantial.

86. Had the Commission not ordered AT&T-C to consolidate its access charge reductions into a memorandum account, the alternative would have been a series of AT&T-C rate adjustments occurring after the period that the California Association of Long Distance Companies alleges its members ceased or greatly reduced their use of AT&T-C WATS service.

87. AT&T-C's advice letter 97 proposes two rate adjustments during the next six months.

88. The Commission's objective of minimizing customer confusion and administrative cost would be better met by a single AT&T-C rate adjustment to end the memorandum account and reflect the other rate impacts of this decision.

89. A uniform percentage rate adjustment for switched services will minimize customer confusion and administrative costs.

90. The private line adjustment included in AT&T's Advice Letter 97 is appropriate to reflect costs.

91. To require AT&T-C to report corporate reorganizations or headquarters operational expense changes which would result in changes in expenses to California operations of less than $100,000 would constitute an undue burden, and alternatively to require lesser records of AT&T-C's expenses and allocated costs would deny the Commission staff the opportunity for reasonable reviews of the utility's operations consistent with future auditing requirements.

Conclusions of Law

1. Notwithstanding DRA's lead position for presenting issues, the requirement for a showing of reasonableness for any and all expenses under review in Phase II of A.85-11-029 should rest fully with AT&T-C.

2. AT&T's reorganization, initiated in 1986, should cut costs, improve the efficiency and the competitive position of AT&T's overall operations for the future.

3. DRA's recommended $3.5 million reorganization adjustment should be proportionately reduced to apply to the authorized rather than budgeted marketing expenses for test year. Failure to do so would have the effect of adopting a greater, $5.3 million adjustment, against the marketing budget than the amount identified by DRA.

4. AT&T-C confirmed that account inquiry, service order entry, account maintenance, and message investigation functions of the customer service and billing program were at least partially in place and used and useful in California during test year 1986;

therefore, some expenses for these functions should be adopted for the test year.

5. Message toll (telecommunications) service (MTS) billing, MTS message processing, MTS credit and collection, and MTS remittance processing functions of the customer service and billing program were not in service during test year 1986 and will not be in service or used and useful until June 1988 or later; therefore, any and all expenses associated with the development of these functions should be excluded from AT&T-C's test year results of operations.

6. The DRA's recommended test year 1986 California intrastate disallowance of approximately $20.1 million and deferral of all expenses associated with the development and deployment of AT&T's customer service and billing program, excepting for account inquiry functions, is insupportable based on the record, which demonstrated that certain other program functions were also used and useful in AT&T-C's California intrastate operations during all or part of 1986; therefore, DRA's recommendation should not be adopted.

7. The modest $5.7 million intrastate expense deferral for its customer service and billing program urged in AT&T-C's closing brief should not be adopted because it was not supported by a record which demonstrates that the LECs still perform significant amounts of work and incur large expenses for billing and collection functions.

8. A $9.1 million intrastate expense deferral in an interest-bearing memorandum account, as computed by DRA at the ALJ's request, should be adopted since it represents a reasonable recognition of some used and useful customer service and billing functions performed by AT&T-C in test year 1986, and the need to preclude cost duplication to AT&T-C's customers for work concurrently performed by the LECs during and well beyond the test year.

9. The overall advertising budget for AT&T-C's test year 1986 operations was adopted in Phase I of this proceeding by D.86-11-079, and further consideration of AT&T-C or AT&T-CH advertising issues is beyond the scope of the limited rehearing granted in D.87-04-041.

10. Sharing the cost of public relations expenses between investors and ratepayers for providing timely, accurate, and consistent information to ratepayers and the general public, regarding changes in available services and to employees regarding changes in corporate functions, direction and reorganization, on a one-time basis after divestiture, is reasonable and should be adopted to the extent specified in this decision.

11. DRA's use of an alternative to its traditional auditing method, involving meetings with departmental representatives of each NOMC department and then reviewing examples of each department's outputs should be accepted as reasonable in view of the lack of availability of accounting records for specific NOMC activities and functions.

12. Access charges, which are collected from ratepayers by AT&T-C and then passed on to the LECs, like taxes, should be excluded from allocation factors used for allocating general services and home office expenses.

13. Direct assignment of general services and home office expenses wherever possible, on a specific project basis, is preferable to any allocation method using representative factors and should be adopted instead of functional allocations in future rate proceedings.

14. American in 1983 passed on to the then Bell System Operating Companies $10.4 million, representing approximately 11% of the after taxes gain on the July 1, 1983 sale of its 195 Broadway headquarters building, including interest; AT&T-C should be required to pass through to its California ratepayers the properly allocated amount of the remaining 89% of the gain on sale

of the 195 Broadway headquarters building based on contributions made by these ratepayers through the predivestiture license contract between PT&T and American.

15. A requirement for Pacific Bell or its predecessor PT&T to bear any additional pass-through expense of the AT&T remaining (89%) gain on sale of the 195 Broadway building, as AT&T-C suggests in its brief, would be unreasonable and should not be adopted herein, since neither of these entities ever received any portion of the (89%) remaining gain on this transaction.

16. The 11-year amortization of the Western Electric adjustment on the assets segregated to AT&T-C from PT&T at divestiture (January 1, 1984) adopted herein represents a reasonable compromise between the interests of AT&T-C's customers and investors, and spreads this adjustment over the remaining useful life of the property involved.

17. No excessive profit has been demonstrated on AT&T-C's purchases from Technologies during the period of January 1, 1984 through the end of 1986, and no affiliated transaction adjustment should be made on these purchases.

18. Limited reporting with some supplemental record-keeping on (post-1986) and future transactions between Technologies and AT&T-C, as heretofore discussed, is reasonable and should be adopted.

19. The investor-related and other services provided by American Transtech to AT&T should be adjusted to provide a return on investment no greater than that authorized for AT&T-C's utility operations.

20. The real business risk associated with the current work Bell Labs performs for AT&T's telecommunications companies has not been shown to be greater than that of the telecommunications utilities themselves; therefore, no greater rate of return should be adopted for Bell Labs than that authorized for AT&T-C.

21. The $300,000 adjustment to AT&T-C's 1986 test year intrastate expenses to bring parity to the return on investment of Bell Labs with that of AT&T-C is the minimum reasonable adjustment which could and should be made in this proceeding.

22. D.86-11-079 authorized an advertising expense allowance of $22,393,000 for test year 1986, and no further issues were raised in Phase II relative to AT&T-C's 1986 advertising budget; therefore, the reasonableness of advertising expenses should not be an issue for consideration in Phase II of A.85-11-029.

23. AT&T-C's intrastate marketing allowance of $44.7 million should be revised to $51.1 million consistent with the preceeding discussion and findings of fact.

24. Any future allocation of marketing expenses to AT&T-C's California operations should be performed by direct assignment based on need and benefit rather than on a percentage of revenue basis as used for this proceeding.

25. Neither Public Utilities Code 453.5 nor California Manufacturer's Association v. Public Utilities Commission (1979) 24 Cal. 3d 836 nor Cory v. Public Utilities Commission (1983) 33 Cal. 3d 522, prevent the Commission from ordering AT&T-C to reflect the balance of its access charge memorandum account in a prospective rate adjustment.

26. AT&T-C should be ordered to reduce its rates to reflect the revenue requirement impacts of this decision.

27. AT&T-C should be ordered to amortize the balance in its access charge memorandum account through a uniform six-month surcredit on switched services.

28. AT&T-C's Advice Letter 97 should be rejected in favor of a uniform switched services rate adjustment and six-month surcredit to be effective July 1, 1988.

29. AT&T-C's private line rate adjustment in Advice Letter 97 should be approved.

O R D E R

IT IS ORDERED that:

1. AT&T Communications of California, Inc.'s (AT&T-C) test year intrastate revenue requirement is reduced by $4.4 million effective January 1, 1987, from the level adopted on an interim basis in D.86-11-079, consistent with the preceding discussion and the adjustments adopted in this decision.

2. AT&T-C Advice Letter 97 is rejected.

3. Within ten days of the effective date of this order AT&T-C shall file an advice letter with revised tariff sheets to reflect a uniform percentage adjustment of its rates and surcharges for switched services consistent with the discussion, findings and conclusions of this decision. The balance in the access charge reduction memorandum account shall be amortized on a uniform basis from July 1, 1988 through December 31, 1988. AT&T-C shall adjust its rates and or surcharges for non-switched services and for the impact of D.88-01-061 consistent with the treatment proposed in Advice Letter 97. The effective date of the ordered revisions shall be July 1, 1988.

4. Consistent with Ordering Paragraph 4 in D.87-10-088, AT&T-C shall file a separate advice letter with revised tariff sheets within ten days of this order to pass through on a uniform basis from July 1, 1988 to December 31, 1988 the balance remaining in the memorandum account associated with that decision. For administrative convenience, AT&T-C shall consolidate the rate changes in Ordering Paragraph 3 with this change to produce a set of consolidated tariff sheets.

5. AT&T-C shall include with the Commission's copies of the advice letter filing, supporting workpapers setting forth the calculations for each of the rate and surcredit changes and resulting rate reduction components and the overall rate reduction. CACD shall verify the proper rate and surcharge changes.

6. Since this order resolves all 1986 test year issues held open in Ordering Paragraphs 2, 15, and 18 of D.86-11-079, this matter is closed.

7. AT&T-C shall file copies of the reports, as set forth in Appendix D, to the addressees specified. This reporting requirement [except for those reports required by General Order 104 and the monthly earnings reports provided pursuant to Ordering Paragraph 8 of D.85-03-056 and General Order 65-A, and the record retention requirements of General Order 28-A] shall terminate upon submission of the reports for calendar year 1992, to be filed on or before March 31, 1993, unless earlier modified, extended, or discontinued by further order of this Commission. Should the Commission grant pricing flexibility to AT&T-C in its A.87-10-039, modifications to these requirements may be appropriate earlier. Parties are directed to discuss the appropriate nature of such modifications in A.87-10-039.

This order is effective today.

Dated June 17, 1988, 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 dissent in part.

/s/ FREDERICK R. DUDA
Commissioner

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

Victor Weisser, Executive Director

APPENDIX A
Page 1

Specific AT&T Corporate Headquarters
[Activity] Expenses Disallowed by the Staff
(As Identified by AT&T Witness Conrad J. Ankiel)

Functional Activity	Description of Activity
I Executive Administrative Expenses [Partial Disallowance]	General Administration of AT&T (including AT&T-C) -- salaries and expenses incurred by the senior executives and their support staffs.
II Public Relations Expense	
Media Relations	Conducting of press relations with national media in New York and Washington by responding to press inquiries and distributing information to the press.
EPCOT/INFOQUEST and Related Administration	Project expenses associated with EPCOT and INFOQUEST.
Corporate Archives and Information Resources	Maintenance and administration of the Corporate Archives/Provision of support services involving research, e.g. analysis of syndicated research data, periodical research, and deriving information from various available computer data bases.
Customer Satisfaction Advertising	Advertising campaign to inform selected constituencies of AT&T's dedication to satisfying customer's information/communications needs -- ads include AT&T Communications personages, long distance service reference, etc.
Ethnic Advertising	Advertising campaign directed toward Black and Hispanic audiences/ Ads build on the customer satisfaction campaign.
Thought Leader Advertising	Advertising campaign directed at vitally important constituencies, e.g. leaders of the business/

Functional Activity	Description of Activity
	financial community -- The campaign communicates the policies and philosophies of AT&T management so as to articulate the company's leadership role in communication and information services.
Corporate Advertising Administration	Administer the development and implementation of advertising programs to ensure that advertising effectively meets customer needs.
Advertising Liaison and Coordination	Coordination of advertising plans and media schedules for the AT&T entities/lines of business (LOB) so that consistent, cohesive and cost effective advertising is created which delivers intended messages to respective target audiences.
Corporate PR Strategies and Information	Establishment of AT&T's public relations strategic planning -- Identification and analysis of critical issues of significance to AT&T entities/LOBs.
Public Relations Survey Activities	Monitoring and assessing AT&T PR activities through surveys, questionnaires, etc.
Corporate Exhibits	Development and management of exhibits for special AT&T Corporate events such as shareowner meetings, community events, etc.
Corporate Underwriting Administration	Administration of corporate underwriting.
MacNeil/Lehrer News	Underwriting "The MacNeil/Lehrer NewsHour."
Cultural Programs	Sponsorship of quality arts programs.

Functional Activity	Description of Activity
Corporate Identity	Assure compliance throughout the entire corporation with all of the elements and requirements of the Corporate Identity Program.
Community and Educational Relations	Community and educational relations including: serving as a clearing house for the exchange of community and educational information; interfacing with consumer organizations and other public constituencies; and fulfilling corporate responsibilities to charitable, educational and cultural organizations.
III Legal	
Joint Venture, Mergers and Acquisitions	Service rendered in connection with legal matters relating to acquisitions, mergers and/or joint ventures.
IV Corporate Finance and Accounting	
Cash Management	Management of the AT&T pool of funds and temporary investments.
Tax Planning and Compliance - "Non-Utility"	Perform strategic and operational tax planning and research for non-utility tax matters, e.g. Federal withholding matters, state/local income taxes, property taxes, business and occupation taxes, capital stock taxes, sales/use taxes, net worth taxes and foreign taxes.
Data Systems Planning/ Information Movement and Management	Guide the activities of AT&T data systems development and support groups.
Financial Analysis	Provide the financial analysis function.

Functional Activity	Description of Activity
Business Planning and Analysis	Manage the AT&T planning process -- Prepare the schedule and guidelines for business plan submission, analyze financial view data provided, and produce the AT&T consolidated view of business plans.
AT&T Investor Relations	Maintain contacts with investors and the financial community.
Internal Audits CH	Perform internal audits as to the operations and activities of AT&T Corporate Headquarters and report results to management.
Joint Ventures	Represent the Finance Department in joint venture/merger/acquisition activity.
Corporate Financing	Provide goals, objectives and policies relating to capital markets, cost of capital, capital formation alternatives, and the impact of external factors on AT&T earnings and financing.
AT&T Foundation	Provide financial administrative support for the AT&T Foundation.
V Corporate Strategy & Development	
Corporate Strategy and Development	Development of integrated corporate plans including analyses and recommendations for the Office of the Chairman on business plans and corporate development options.
Corporate Planning Models	Provision of analytical models and analytical techniques associated with AT&T strategies.

APPENDIX A
Page 5

Functional Activity	Description of Activity
Venture Technologies	Provision of assistance in the identification, nurturing and implementation of internal ventures.
Corporate Communications	Formulation and monitoring of AT&T's corporate communications policy and objectives.

(Source: Ex. 236, Attachment C, Sheets 1-6.)

(END OF APPENDIX A)

APPENDIX B
Page 1

Glossary of Acronyms

A.	Application
ALJ	Administrative Law Judge
American	American Telephone and Telegraph Company (Predivestiture predecessor of AT&T)
AT&T[1]	AT&T Corporation (Parent)
AT&T Communications[1]	AT&T Communications, Inc. (same as NOMC)
AT&T-C[1]	AT&T Communications of California, Inc. (Applicant in this proceeding)
AT&T-CH[1]	AT&T-Corporate Headquarters
AT&TIS[1]	AT&T Information Systems, Inc.
BDP	Budget Decision Package
Bell Labs[1]	AT&T Bell Laboratories, Inc. (Called Bell Telephone Laboratories, Inc. before divestiture)
C.	Case
CACD	Commission Advisory and Compliance Division of the California Public Utilities Commission
CALTEL	California Association of Long Distance Telephone Companies
Churn	Customer <u>reselection</u> of interexchange carriers after equal access initial selection was first made.
Cl. Br.	Closing Brief

1 See Summary of Decision section of this order for further details of AT&T's organizational structure.

APPENDIX B
Page 2

Glossary of Acronyms

CPI	Consumer Price Index
D.	Decision
DRA	Division of Ratepayer Advocates of the California Public Utilities Commission
E&C	Evaluation and Compliance Division (Predecessor of CACD)
Ex.	Exhibit
FCC	Federal Communications Commission
F/MBE	Female/Minority Business Enterprises
General	GTE California Incorporated (formerly General Telephone Company of California)
IEC	Interexchange carrier (such as AT&T-C, Allnet, Execulines, Inc., MCI, Starnet, U.S. Sprint, Western Union, and others)
LATA	Local Access and Transport Area
LEC	Local Exchange Company (One of the 22 telephone companies who provide local exchange and intraLATA telephone service in California. The term LEC's represents all 22 of these companies.)
LOB	Lines of Business
MCI	MCI Telecommunications Corporation
MTS	Message Toll [Telecommunications] Service
NARUC	National Association of Regulatory Utility Commissioners

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1 See Summary of Decision section of this order for further details of AT&T's organizational structure.

Glossary of Acronyms

NOI	Notice of Intent
NOMC[1]	AT&T Communications, Inc.-National Operations and Management Corporation
OII (also I.)	Order Instituting Investigation
Op. Br.	Opening Brief
PHC	Prehearing Conference
POP	Points of Presence
PSD	Public Staff Division (Predecessor of DRA)
PT&T	The Pacific Telephone and Telegraph Company (Predivestiture predecessor of Pacific Bell)
PU Code	The California Public Utilities Code (Reference is usually followed by a section number.)
R&D	Research and Development
RD&D	Research, Development and Demonstration
ROI	Return on Investment
SLU	Subscriber Line Usage This is an allocation factor which is a measure of the relative usage of each subscriber of exchange and toll telephone service. It is based on the actual minutes of use of each service. This factor dates back to the 1947 Telephone Separations Manual.
SNFA	Shared Network Facilities Arrangement

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1 See Summary of Decision section of this order for further ddetails of AT&T's organizational structure.

APPENDIX B
Page 4

Glossary of Acronyms

SPF	Subscriber Plant Factor This is an allocation factor in which the minutes of use are weighted by a complex formula which reflects the average length of haul of each call. This factor was prescribed by the 1971 (Ozark Plan) Telephone Separations Manual.
Technologies[1]	AT&T Technologies, Inc. (Post-divestiture successor to Western Electric Company, Inc.)
Tr.	Transcript
TURN	Toward Utility Rate Normalization (An intervenor, based in San Francisco, who represents residential and small business ratepayers)
U.S. Sprint	U.S. Sprint Communications Company
USOA	Uniform System of Accounts
WATS	Wide Area Telephone Service
Western	Western Electric Company, Inc. (Predivestiture predecessor of AT&T Technologies, Inc.)

1 See Summary of Decision section of this order for further details of AT&T's organizational structure.

(END OF APPENDIX B)

THE NEXT 1 DOCUMENTS ARE POOR ORIGINALS

MICROFILMING SERVICES WILL NOT ASSUME RESPONSIBILITY FOR THE IMAGE QUALITY

AT&T COMMUNICATIONS OF CALIFORNIA
Adopted Total Company & Intrastate Summary of Earnings
Phase II/A.85-11-029
Test Year 1986
(Thousands of Dollars)

		Total Company	Intrastate
	REVENUES		
1	Toll	$3,170,051	$1,705,524
2	Contracts	37,443	37,443
3	Uncollectibles	(62,708)	(26,095)
4	Total Revenues	3,144,786	1,716,872
	OPERATING EXPENSES		
5	Access Charges	1,901,993	1,103,673
6	Billing Charges	232,552	176,081
7	Maintenance	87,894	35,339
8	Depreciation	114,013	60,235
9	Traffic	145,254	56,649
10	Commercial	139,359	59,877
11	Operating Rents	93,431	39,744
12	Executive & Legal	5,090	1,930
13	Accounting	59,577	10,349
14	Relief & Pension	56,677	21,865
15	General	80,454	31,835
16	Other Expenses	(1,263)	(525)
17	Audit Adjustments	(52,758)	(11,654)
18	Subtotal	2,862,273	1,585,403
	TAXES		
19	CCFT	12,827	4,562
20	FIT	70,319	24,043
21	Gross Receipts	46,184	46,184
22	Other Operating Taxes	38,484	15,341
23	Total Expenses	3,030,086	1,675,533
24	Net Revenues	114,700	41,339
	RATE BASE		
25	Avg. Tel. Plant in Serv.	1,330,675	591,739
26	Avg. Plt. Under Const.-S. T.	0	0
27	Avg. Plt. Held for Fut. Use	275	155
28	Working Cash Allowance	77,798	43,326
29	Materials & Supplies	4,618	1,788
30	LESS: Depreciation Reserve	427,360	187,970
31	LESS: Deferred Taxes	165,811	80,399
32	Total Rate Base	820,195	368,639
33	RATE OF RETURN	13.98%	11.21%

APPENDIX C
Page 2

AT&T COMMUNICATIONS OF CALIFORNIA
Revenue Requirement
Phase II/A.85-11-029
Test Year 1986
(Thousands of Dollars)

	Results of Operations @ Present Rates	Adopted
1	Operating Revenues	$1,716,872
2	Operating Expenses and Taxes	1,675,533
3	Net Operating Revenues	41,339
4	Rate Base	368,639
5	Rate of Return	11.21%

	Revenue Requirement Calculations	
6	Estimated 1986 rate base	368,639
7	Adopted rate of return	12.35%
8	Net revenue requirement	45,527
9	Less: Estimated 1986 net revenues	41,339
10	Increase in net revenue requirement	4,188
11	Net-to-gross multiplier	1.8813
12	Increase in gross revenue requirement [1]	$7,879

[1] This amount represents the combined results of both Phase I and Phase II of this proceeding. Phase I resulted in an increase in revenue requirement of $12,264; the $4,385 adjustments adopted in Phase II lowered that increase to $7,879.

(END OF APPENDIX C)

APPENDIX D
Page 1

Reporting and Record-Keeping

A. Reporting Requirements

1. Nothing here is intended to change, revise, modify, or discontinue AT&T-C's regular reporting requirements under General Order 104 and its submission of monthly earnings reports pursuant to Ordering Paragraph 8 of D.85-03-056 and General Order 65-A, or the preservation of records as specified in General Order 28-A.

2. AT&T-C shall, on or before March 31, 1989, and in each subsequent year, submit to the Deputy Director of the Division of Ratepayer Advocates, an original and one copy of a report detailing transactions between AT&T-C and Technologies, during the past calendar year. The report will contain:

a. AT&T-C's construction budget.

b. Amount of AT&T-Communications of California's purchases from Technologies (estimated for expense and plant categories), and

c. Capital structure of Technologies.

AT&T-C and Technologies shall arrange to retain, but not report annually, respective accounting records, including such memorandum accounts as necessary, in a manner which would permit the development of "Realized rate of return of Technologies sales to AT&T-C of California by line of business," for AT&T-C's next rate application or rate investigation. The original of the report required herein will be routed by DRA's Deputy Director to the Director of the Commission Advisory and Compliance Division for compliance review by that division and then to the formal file in this proceeding for access and review by interested parties.

This new reporting requirement shall terminate upon submission of the reports for calendar year 1992, to be filed on or before March 31, 1993, unless earlier modified, extended, or discontinued by further order of this Commission.

B. Record-keeping Requirements

AT&T-C shall arrange with AT&T-CH and AT&T-Communications (NOMC) to maintain those accounting records and memorandum accounts necessary to respond promptly to DRA's requests for information regarding the following activities and categories of expenses in its next rate proceeding:

- o Corporate Reorganizations
- o Advertising and Marketing Cost/Benefits
- o Billing and Collection Program Development and Deployment
- o "Side Records" as a proxy for Account 674 data per D.87-12-063.
- o Corporate Headquarters Allocations
- o AT&T Communications (NOMC) Headquarters and Field Allocations.

These record-keeping requirements, in anticipation of future rate proceedings, are more precisely, but not exclusively, defined as follows:

1. Corporate Reorganization

Tracking records for reorganizations would include the following DRA requested information:

"a. The implementation plan including a schedule of staff changes, whenever this information becomes available;

"b. Track all costs associated with the reorganization plan, including employee relocation costs, by organization and type identifying direct and shared costs;

"c. Maintain monthly reports on costs tracked;

"d. Identify the total effect of these costs in allocations to California;

"e. Provide a final report upon completion of reorganization including the total economic impact."

2. Advertising and Marketing Cost/Benefits

AT&T-C shall arrange to maintain accounting records and memorandum accounts, as necessary, to permit it to comply with Ordering Paragraph 5 of this decision when it files any future rate application, as follows:

> "In future rate proceedings, if AT&T-C wishes California ratepayers to bear a share of allocated advertising and marketing expenses, it shall present a cost/benefit analysis in its direct showing, over the latest available 12-month recorded period, as well as its pro forma analysis of future commercial expenses. This analysis should be developed to include justification that its marketing expenditures provide a proven cost/benefit to its small, medium, and large use customers."

3. Customer Service and Billing Program

AT&T-C is authorized to place $9.1 million of the California intrastate expenses, so allocated from AT&T's development and deployment of its customer service and billing program, into an interest-bearing memorandum account to accrue interest at the average three-month commercial paper rate as published in the Federal Reserve Bulletin. This will permit AT&T-C to recover these costs upon a further determination of prudency of AT&T-C's take-back of its message billing service from the LECs and its own introduction of direct billing, which will necessarily be a future rate proceeding.

4. General Expenses of Corporate Headquarters

Pursuant to D.87-12-063 issued December 22, 1987 in I.87-02-023, AT&T-C was exempted from a requirement to reinstate "Account 674, General Services and Licenses." However, in lieu thereof, D.87-12-063 contained the following proviso which will apply to DRA's request for future reporting requirements herein as well:

> "g. AT&T shall maintain its data on affiliate company costs on a side record basis and shall not be required to set up a separate and unique subaccount code to record these costs." (D.87-12-063, mimeo. p. 48.)

5. <u>Allocation of Corporate Expenses</u>

AT&T-C, in cooperation with AT&T-CH and AT&T Communications (NOMC), should wherever possible use more direct allocations of headquarters expenses for rate-fixing purposes where the direct beneficiaries can be identified.

AT&T-C, in cooperation with AT&T Communications (NOMC), should discontinue the use of access charges in allocation factors.

The record-keeping requirements set forth in B.1 through B.5 above shall terminate, except for Item B.4, upon the conclusion of AT&T-C's next general rate proceeding or calendar year December 31, 1993, whichever occurs later, unless earlier modified, extended, or discontinued by further order of this Commission.

(END OF APPENDIX D)

A.85-11-029
D.88-06-036

Commissioner Duda, Dissenting in Part:

I feel the need to explain why I believe that the refund proposed by ALJ Amaroli is superior to the prospective rate reduction authorized by today's decision.

As the ALJ pointed out, avoidance of all review of prior customer usage and the setting of future rates at less than cost in order to amortize the prior overcollections through future rate reductions is both unreasonable and unfair. Such a method sends a signal to customers that they must purchase additional service, whether they need it or not, to receive through bargain rates an amount equal to their prior overpayment.

The ALJ's refund proposal was carefully tailored to give the excess money collected by AT&T-C back to those AT&T-C customers and former customers who overpaid in the first place. The adopted decision, however, instead only benefits present customers of AT&T-C who, in the next six months, make as many, or more, long distance calls than they did in the past six months.

As the ALJ further points out, the use of future rate reductions to refund past overcollections is also unfair to AT&T-C's interexchange carrier competitors. By allowing AT&T-C to price its services well below cost, AT&T-C gains a considerable competitive advantage over its business rivals. While major rivals such as US Sprint and MCI may grudgingly take this in stride, the effect of today's decision will be much more serious for the dozens of smaller interexchange carriers operating in California.

Today's decision sends the signal that we are willing to grant the dominant player in the long-distance marketplace a very significant competitive advantage simply because to do so is easier than making even a minimal effort to match up the prior overcollections with the customers who have contributed to those overcollections. This signal seems contrary to our profession of interest in ensuring the viability of a competitive long-distance marketplace.

Support for a one-time refund can easily be found here from the facts. The application of Public Utilities Code 453.5 (as guided by the Supreme Court's direction to us in the Cory and California Manufacturers' cases) strongly supports the reasonableness of a one-time refund. I would so order.

/s/ Frederick R. Duda
Frederick R. Duda, Commissioner

June 17, 1988
San Francisco, California

ALJ/GA/jt

Decision 88 06 036 JUN 17 1988

Mailed

JUN 22 1988

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ORIGINAL

In the Matter of the Application of AT&T COMMUNICATIONS OF CALIFORNIA, INC., a corporation, for authority to increase certain intrastate rates and charges applicable to telecommunications services furnished within the State of California (U 5002 C).)	Application 85-11-029 (Filed November 18, 1985)

(See Decision 86-11-079 for appearances.)

I N D E X

I N D E X

INDEX

OPINION

I. Summary of Decision

This Phase II decision concludes the Commission's review and analysis of AT&T Communications of California's (AT&T-C) audited test year 1986 results of operation.

This decision further reduces AT&T-C's test year 1986 total California operational expenses by $46.745 million ($9.6 million on an intrastate basis), and reduces its total California rate base by $15.51 million ($6.1 million on an intrastate basis) from the Decision (D.) 86-11-079 adopted results. These changes result in an annual gross revenue reduction of $10.5 million on AT&T-C's California intrastate operations. This reduction is spread proportionately to reduce AT&T-C's intrastate long distance (including coin-sent calls) 800, WATS and private line service.

By this order AT&T-C is also directed to make a one-time refund of approximately $116 million to its customers for appropriate amounts collected subject to refund pursuant to D.86-11-079 and for flowing through the results of D.87-12-051, D.87-12-067, D.87-12-070, D.87-10-088, and D.88-01-061 concerning access charges, Universal Lifeline Telephone Service tracking and the Tax Reform Act of 1986, which affect the amounts collected by AT&T-C in rates it collected and retained with interest in excess of its allowable expenses.

In D.86-11-079 the Commission held back $15.058 million of AT&T-C's total California operating expenses ($5.754 million on an intrastate basis) pending Phase II hearings on Public Staff Division's[1] audit report. The Commission also made the rates authorized in D.86-11-079 subject to refund.

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1 Since renamed "Division of Ratepayer Advocates (DRA).

OPINION

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This decision further reduces AT&T-C's test year 1986 total California operational expenses by $46.591 million ($9.5 million on an intrastate basis), and reduces its total California rate base by $15.51 million ($6.1 million on an intrastate basis) from the Decision (D.) 86-11-079 adopted results. These changes result in an annual gross revenue reduction of $10.4 million on AT&T-C's California intrastate operations. This reduction is spread proportionately to reduce AT&T-C's intrastate long distance (including coin-sent calls) 800, WATS and private line service.

By this order AT&T-C is also directed to make a one-time refund of approximately $118.9 million to its customers for appropriate amounts collected subject to refund pursuant to D.86-11-079 and for flowing through the results of D.87-12-051, D.87-12-067, D.87-12-070, D.87-10-088, and D.88-01-061 concerning access charges, Universal Lifeline Telephone Service tracking and the Tax Reform Act of 1986, which affect the amounts collected by AT&T-C in rates it collected and retained with interest in excess of its allowable expenses.

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Since the receipt and review of the DRA's audit report was the main thrust of Phase II, DRA was placed in a lead posture. However, even though DRA made the initial presentation for all issues in the Phase II hearings, and its position is routinely discussed first in each section of this order, it is clear that the burden of proof for the reasonableness of all expenses rests with AT&T-C under Public Utilities Code (PU Code) Section 454. Therefore, the requirement for a showing of reasonableness of any and all expenses under review herein for Phase II of Application (A.) 85-11-029 still rests fully with AT&T-C.

A. Summary of Recommended and Adopted Phase II Changes in Results of Operations

1. DRA's Position

In Phase II, DRA recommended further disallowances in addition to the amounts the Commission held back in D.86-11-079. DRA's recommendations were vigorously cross-examined by AT&T-C and DRA's final position in Exhibit 243 was changed somewhat from its initial audit report recommendation (Ex. 201).

In Exhibit 243 DRA recommended further expense reductions of $100 million for AT&T-C's total California operations and $29 million on intrastate operations, over and above the amounts [$15.0 million for total California and $5.8 million intrastate operations] held back by D.86-11-079 pending the staff audit.

A detailed breakdown of DRA's recommended Phase II adjustments is set forth in the table which follows AT&T-C's position below.

2. AT&T-C's Position

In Phase II AT&T-C requested that the Commission find its 1986 test year headquarters and other allocated corporate expenses reasonable and appropriate as costs of service for its California customers. AT&T-C then requested an additional $39.7 million allowance for marketing expenses on its total California operations ($18.0 million on an intrastate basis) and the setting aside of the

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In Exhibit 243 DRA recommended further expense reductions of $100 million for AT&T-C's total California operations and $29 million on intrastate operations, over and above the amounts [$15.1 million for total California and $5.8 million intrastate operations] held back by D.86-11-079 pending the staff audit.

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audit hold-back of $15.1 million ($5.8 million on an intrastate basis) with no adjustments to its intrastate rate base. AT&T-C's request, if approved, would raise AT&T-C's intrastate revenue requirement for test year 1986 by $22.6 million as set forth in the following table.

The figures contained in the "Comparison of Adjustments" and Appendix C tables are rounded to the nearest $100,000 in accordance with the rounding practice used in D.86-11-079. Therefore, it follows that occasionally the dollar amount set forth in the summary tables may be $100,000 higher or lower than the adopted result in any given section of this order.

These rounding changes tend to average out and thus do not alter the significance of any given adjustment, or seriously affect the overall result.

AT&T COMMUNICATIONS OF CALIFORNIA
Comparison of Adjustments
Phase II/A.85-11-029
Test Year 1986
(Thousands of Dollars)

		Total California			Intrastate			Rev. Req. Effect		
		DRA Exn. 243	AT&T-C* Position	Adopted	DRA Exn. 243	AT&T-C* Position	Adopted	DRA Exn. 243	AT&T-C* Position	Adopted
	OPERATING EXPENSES									
1	Public Relations	$2,900	$0	$1,700	$1,100	$0	$600	$1,100	$0	$600
2	Reorganization	3,600	0	2,300	1,500	0	1,000	1,400	0	1,000
3	Allocation less Rev.	11,100	0	0	4,700	0	0	4,500	0	0
4	Allocation less Access & Rev.	5,200	0	4,800	2,100	0	1,900	2,000	0	1,800
5	Billing & Collection	79,100	0	46,100	20,100	0	9,100	19,100	0	8,700
6	Corp. Headquaters							4,000	0	2,100
7	AT&T-HQ	-7,100	0	4,600	2,800	0	1,800			
8	Gain on 195 Broadway	2,300	0	0	900	0	0			
9	AT&T Tech.	2,700	0	1,000	1,200	0	500	2,100	0	1,300
10	American Transtech	200	0	200	100	0	100	100	0	100
11	R&D & Fund. Research	900	0	900	300	0	300	300	0	300
12	Marketing	0	(39,700)	0	0	(18,000)	0	0	(17,100)	0
	Subtotals b/4 audit adj.	115,100	(39,700)	61,600	34,800	(18,000)	15,300	34,600	(17,100)	15,900
14	LESS: Audit adj. in D.86-11-079	15,100	15,100	15,100	5,800	5,800	5,800	5,500	5,500	5,500
15	Total Expense Adjustments	100,000	(54,800)	46,500	29,000	(23,800)	9,500			
16	Total Rev. Req. Effect							29,100	(22,600)	10,400
	RATE BASE									
17	AT&T Tech. Calif.	9,500	0	10,300	3,800	0	4,100			
18	Gain on 195 Broadway	5,900	0	5,200	2,300	0	2,000			
19	Total Rate Base Adjustments	15,400	0	15,500	6,100	0	6,100			

* As set forth in AT&T-C's Opening and Closing Briefs.
() Denotes increase in expenses or revenue requirement.

3. Brief Summary of Adopted Adjustments

The following discussion provides a brief statement regarding each of the expense and rate base adjustments listed in the adopted columns of the previous table. A more comprehensive discussion of any given adjustment is contained in the "Discussion" for the section of this decision dealing with that issue and adjustment.

a. Public Relations

This decision reduces DRA's proposed 97.85% disallowance of corporate and field public relations expenses by 41.4%, resulting in an allowance of about 42.7% of such expenses. DRA recommended that we exclude $2.9 million for AT&T-C's total California ($1.1 million intrastate) operations. With the reinstated expense allowance, the adopted adjustments are reduced to $1.7 million for total California and $.6 million for intrastate operations.

The reinstated amounts are intended to cover the noted percentages of the following expenses:

- 25% of "Media Relations"
- 75% of "Employee Communications"
- 50% of "Consumer Affairs"
- 100% of "Policy Briefings"

These public relations functions and activities are found to be necessary on a one-time basis (for one rate case cycle) at or shortly after divestiture as AT&T Corporation's (Parent) (AT&T) overall corporate structure changed to meet its new functional environment and inform its employees, the media, and the general public about its post-divestiture organization, functions, and available utility services.

b. <u>Reorganization</u>

This decision adopts DRA's identified minimum expense savings for AT&T's major corporate reorganization undertaken in 1986. However, since these cost savings were largely associated with AT&T's overall marketing activity, the amount of the expense savings recommended by DRA is proportionately reduced by the ratio of D.86-11-079 adopted marketing expense to the total marketing expense budgeted for the test year.

The resulting adopted reorganization savings are $2.3 million for AT&T-C's total California ($1.0 million intrastate) operations.

c. <u>Allocations Less Revenue</u>

DRA urged that revenues not be used (in this case exclusively) for allocation of marketing expenses and recommended disallowance of $11,100 million in expenses for AT&T-C's total California ($4.7 million intrastate) operations. While DRA's recommendation is sound, it is not being adopted. Since the D.86-11-079 adopted statewide marketing allowance of $104.23 million is not being changed by this order, it would not be appropriate to reduce it by over 10% by simply applying a different allocations method here, after the fact.

d. <u>Allocation Less Access and Revenues</u>

DRA adjusted the allocation method used by AT&T Communications, Inc., to functionally allocate certain headquarters, corporate, and nationwide expenses to AT&T-C. DRA's allocation method removes access charges from expenses, and deletes <u>revenue and access charges</u> from the composite factor. Access charges were removed on the basis that these charges are merely collected by AT&T-C and passed on to the local exchange telephone companies. The result is a two-factor allocation method rather than the three-factor method used by AT&T, and is too severe for reasonable acceptance.

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d. Allocation Less Access and Revenues

DRA adjusted the allocation method used by AT&T Communications, Inc., to functionally allocate certain headquarters, corporate, and nationwide expenses to AT&T-C. DRA's allocation method removes access charges from expenses, and deletes revenue and access charges from the composite factor. Access charges were removed on the basis that these charges are merely collected by AT&T-C and passed on to the local exchange telephone companies. The result is a two-factor allocation method rather than the three-factor method used by AT&T, and is too severe for reasonable acceptance.

The three-factor allocation method adopted herein removes access charges from revenues and expenses and substitutes, a usage factor in lieu of the revenue factor which is, by coincidence, almost the same as AT&T Communications' 1986 revenue factor recomputed to exclude access charges. The adopted adjustment is a $5.0 million expense reduction for AT&T-C's total California ($2.0 million intrastate) operations.

e. Billing and Collection

This decision directs AT&T-C to set up an interest-bearing memorandum account and place $9.1 million of California intrastate expenses into it, related to the development and deployment of its customer service and billing program which was not fully in place and used and useful during test year 1986. This account will be maintained until AT&T-C's separate billing program is fully operational and used and useful in California.

DRA has recommended the deferral of $79.1 for AT&T-C's total California operations ($20.1 million on an intrastate basis) on the belief that only the account inquiry function was in place and used and useful during the test year.

AT&T-C, on the other hand, suggested, for the sake of argument, a limited deferral of $5.7 million on its intrastate operations until commencement of its direct intrastate toll billing.

This order adopts as reasonable DRA's minimum alternative adjustment of $9.1 million on AT&T-C's intrastate operations as discussed above. This decision also finds that those customer service and billing program functions which were fully implemented, used and useful and not duplicated by the local exchange telephone companies during test year 1986, were developed and deployed in a reasonable and prudent manner by AT&T-C.

f. AT&T-Corporate Headquarters (AT&T-CH)

DRA recommended an adjustment of $7.1 million for investor-related services allocated to AT&T-C's total California operations ($2.8 million intrastate) using a new "equal-to-all" allocations method first adopted in D.86-01-026 issued January 10, 1986 for Pacific Bell's test year 1986 rate case.

However, since we do not adopt DRA's equal-to-all allocations method, the adopted adjustments to AT&T-C's expenses, for corporate and investor-related functions and activities, are reduced to $4.6 million for AT&T-C's total California ($1.8 million intrastate) operations in test year 1986.

g. Gain on Sale of 195 Broadway Building

This decision directs AT&T-C to place $2.0 million in a memorandum account to be credited to its California intrastate rate base representing 75% of the allocated portion of the previously retained (not passed through to ratepayers) gain on sale of AT&T's 195 Broadway, New York headquarters building.

DRA recommended that the allocated gain on sale be expensed over a three-year period at $882,000 per year for AT&T-C's intrastate operations. This order instead adopts a one-time rate base adjustment which has the advantage of being entirely prospective and would essentially have the same effect as it would have had if accomplished in 1983.

h. AT&T Technologies, Inc. (Technologies)

This decision adopts a rate base adjustment of $4.1 million on AT&T-C's California intrastate rate base to be amortized over 11 years, as suggested by AT&T-C, for the remaining predivestiture Western Electric plant adjustment for rate base allocated to AT&T-C at the time of divestiture.

This treatment also includes a $1.0 million adjustment to AT&T-C's total California expenses ($.5 million on an intrastate basis) for test year 1986. This adopted rate base and expense adjustment is based entirely on pre-1984 purchases from Western Electric by The Pacific Telephone and Telegraph Company (PT&T). No new plant adjustments are made for purchases made by

AT&T-C in 1984 through 1986 from Technologies since there was no determination of any excessive rate of return enjoyed by Technologies during those years.

DRA had recommended a four-year amortization of the predivestiture plant adjustment which would have resulted in a greater adjustment to AT&T-C's test year 1986 operations, but we find the 11-year amortization consistent with (1) the life of the property involved and (2) the 13-year remaining service life of the comparable property allocated to Pacific Bell in 1984.

This decision also requires modest record-keeping and reporting of AT&T-C's purchases from Technologies together with record-keeping which would allow it to determine the return realized on these intercompany sales, for review in any subsequent AT&T-C rate proceeding or investigation.

i. <u>American Transtech</u>

This decision adopts DRA's recommended total California expense adjustment of $200,000 ($100,000 on an intrastate basis) on the American Transtech allocated expenses to AT&T-C.

This adjustment follows the long-standing Commission practice of allowing affiliated companies the same rate of return for any given year as that authorized for the utility's operations, on the business performed for the utility.

j. **Research and Development (R&D) <u>Funding - Bell Labs' R&D</u>**

This decision adopts a modest DRA recommended adjustment of $900,000 for AT&T-C's total California ($300,000 intrastate) operations to allow Bell Telephone Laboratories, Inc. (Bell Labs) to earn the same return as was authorized for AT&T-C in test year 1986.

A case could likely have been made to first disallow certain research and development projects as being non-beneficial to the California ratepayers of AT&T-C. While Toward Utility Rate

Normalization (TURN) argued for such a disallowance in Phase I, neither TURN nor DRA developed any record in Phase II to support such a disallowance.

This order also sends a strong signal to the parties that a more comprehensive showing of the benefits (or lack thereof) of Bell Labs' research will be expected in future rate proceedings.

k. <u>Marketing</u>

This decision concludes, after extensive review of the record and the arguments presented, that the $104,230,000 allowance for marketing activities adopted in D.86-11-079 for AT&T-C's total California test year 1986 operations, developed from a 1984 base year, is an adequate amount of overall marketing expenses. It also concludes that AT&T-C's combined marketing and advertising allowance of $126,623,000 on a statewide basis represents a substantial $8.90 for each of the state's estimated 14.2 million access lines in 1986, especially when compared to the $67.5 million allowance (which equated to $5 for each of its 13.5 million access lines) found reasonable for test year 1984 (D.84-06-111).

Therefore, this order does not change the base year for analysis of, or otherwise modify, the adopted marketing allowance adopted in D.86-11-079.

This decision also credits TURN with contributions to the record on the reasonableness of AT&T-C's marketing test year allowance and again adopts TURN's recommendation for a requirement that:

> "In future proceedings, if AT&T-C wishes California ratepayers bear a share of allocated advertising and marketing expenses, it shall present a cost benefit analysis in its direct showing, over the latest available 12-month recorded period, as well as its pro forma analysis of future commercial expenses."

B. Summary of Earnings

The adopted summary of earnings for AT&T-C's total California operations and its California intrastate operations is set forth in Appendix C to this order.

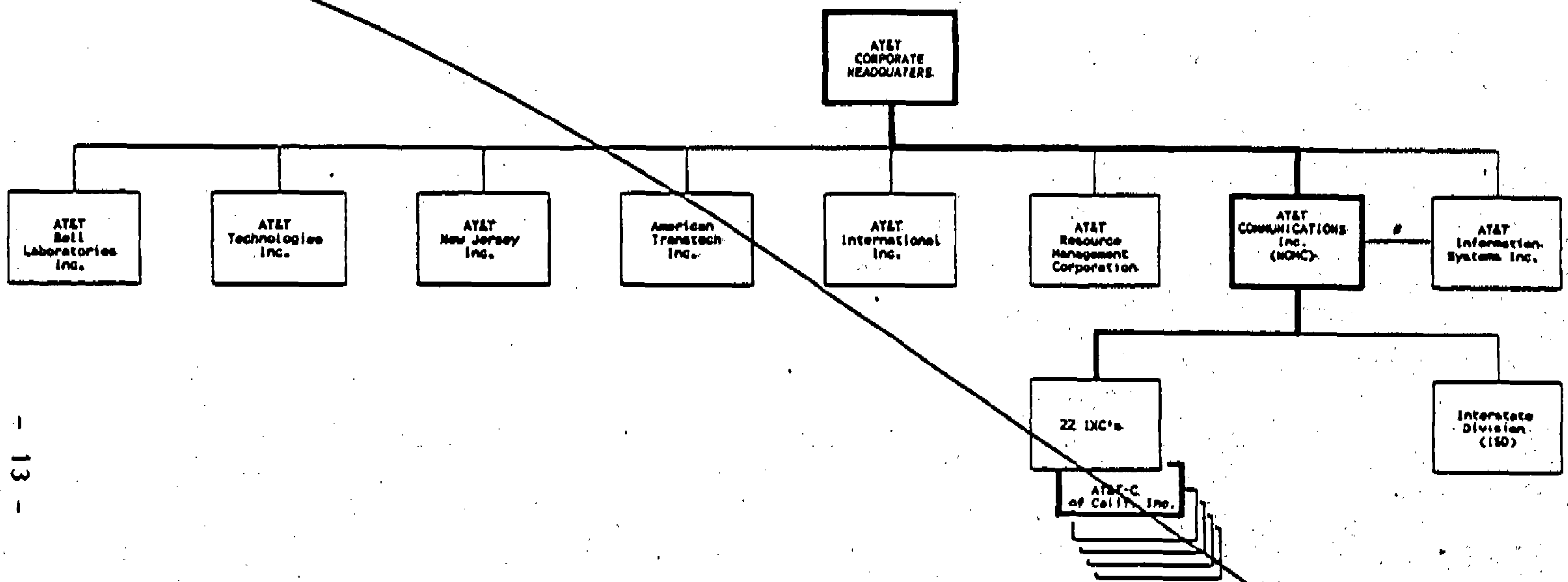
C. Organization of AT&T

To facilitate review and analysis of the various corporate headquarters, general office, and affiliated transactions under scrutiny in this proceeding, a clear understanding of the AT&T Corporation organization structure is crucial. The "AT&T Organization (Legal Structure)" chart, which follows, depicts the test year 1986 organization of AT&T.

The line of corporate control between AT&T-CH and AT&T-C, through AT&T Communications, Inc. (NOMC) which will be described in detail in the various sections of this order, is highlighted on the organization chart. The various affiliated companies and subsidiaries are also shown on the following chart and list of AT&T Communications, Inc. companies.

AT&T Organization (Legal Structure)

Test Year 1986



Notes: Bold lines and boxes depict line of corporate control from AT&T Corporate Headquaters (AT&T-CH) to AT&T-C (applicant)

AT&T-IS activities are gradually being merged with AT&T Communications, Inc.

Source: Exhibit 201, Appendix II-1, Sheets 2 of 2 and Appendix II-2

22 Interexchange Operating Companies of AT&T Communications, Inc.

1. AT&T Communications of Maryland, Inc.
2. AT&T Communications of Virginia, Inc.
3. AT&T Communications of Washington, D.C., Inc.
4. AT&T Communications of West Virginia, Inc.
5. AT&T Communications of New Jersey, Inc.
6. AT&T Communications of Delaware, Inc.
7. AT&T Communications of Pennsylvania, Inc.
8. AT&T Communications of Illinois, Inc.
9. AT&T Communications of Indiana, Inc.
10. AT&T Communications of Michigan, Inc.
11. AT&T Communications of Ohio, Inc.
12. AT&T Communications of Wisconsin, Inc.
13. AT&T Communications of New England, Inc.
14. AT&T Communications of New York, Inc.
15. AT&T Communications of Mid West, Inc.
16. AT&T Communications of South West, Inc.
17. AT&T Communications of Southern State, Inc.
18. AT&T Communications of The South Central State, Inc.
19. AT&T Communications of The Mountain States, Inc.
20. **AT&T Communications of California, Inc. (AT&T-C) (Applicant)**
21. AT&T Communications of Nevada, Inc.
22. AT&T Communications of The Pacific Northwest, Inc.

D. Acronyms

Throughout this decision acronyms are used to avoid repeating lengthy names of entities or things frequently discussed. These acronyms are also commonly used by telephone companies and DRA staff in their exhibits and testimony. Each acronym is usually identified initially by its regular (longer) name. A complete glossary of these acronyms is set forth in Appendix B to this order.

II. Background

On November 14, 1986, the Commission issued Interim D.86-11-079 in this proceeding, which increased AT&T Communications of California's (AT&T-C) test year 1986 intrastate revenue requirement by $8.391 million and granted AT&T-C a 14.25% return on equity and 12.35% rate of return on its intrastate operations.

D.86-11-079 decided the following issues for AT&T-C's test year 1986 operations:

1. 1986 forecasts of demand, revenues, and access charge expenses,
2. Marketing and advertising expenses,
3. Capital recovery and depreciation,
4. Maintenance, traffic, and general office expenses,
5. Working cash,
6. Rate of return,
7. General Order 77-J compliance,
8. Nodal architecture and Points of Presence (POP) deployment plans,
9. Female/Minority Business Enterprises (F/MBE) compliance; and,
10. Rate design.

A number of issues were held over to a second phase of this proceeding to receive additional evidence, after conclusion of a staff audit, undertaken at the earlier direction of the Commission (D.85-03-056, mimeo. p. 9).

The DRA audit was initiated in the fall of 1985; however, due to work on other assignments, and the sheer magnitude of the task of reviewing literally thousands of documents, and interviewing many managers in California, New Jersey, and New York, this audit was not completed until several weeks after the conclusion of the evidentiary hearings on July 3, 1986. Due to the breadth of the audit, responsive information continued to be received right up to the publication of the audit report on July 31, 1986. In that report, the auditors recommended deferred recovery of billing program expenses and proposed ratemaking disallowances for a broad range of other expenses, incurred by AT&T Corporation (Parent) (AT&T) directly or through affiliated companies.

Following its review of the audit report, AT&T expressed its concern that numerous errors and misunderstandings were reflected therein. Accordingly, with the express approval of the [then] assigned administrative law judge (ALJ), AT&T met with, and provided additional information to the auditors, in October 1986 and thereafter, in an effort to reconcile factual differences.

When it became apparent that the audit report issues could not be resolved prior to issuance of the interim decision, the Commission deferred the review of DRA's audit to a second phase of this proceeding with hearings to "commence in the summer of 1987" (D.86-11-079, mimeo. p. 26).

On September 25, 1986 AT&T-C filed a "Petition to Set Aside Submission of the Record for the Taking of Limited Additional Evidence" relative to then recent changes in its provision of services and facilities to Pacific Bell under "Shared Network Facilities Arrangements" (SNFA). After considerable discussion the

Commission adopted AT&T-C's updated SNFA figures, adjusted to reflect other revenue and expense estimates in D.86-11-079, subject to refund after further hearings in Phase II of this proceeding.

To maintain the status quo established by D.84-06-111 issued June 13, 1984 in A.82-11-07 on issues relative to the Western Electric Adjustment, finance and public relations expenses until the DRA staff audit could be received in Phase II, the Commission held back $15.058 million ($5.754 million on an intrastate basis) from AT&T-C. The Commission also made the rates authorized by D.86-11-079 subject to refund in recognition of DRA auditors' recommendations for other possible adjustments, which otherwise appeared to be settled in Phase I.

Then by D.87-04-041 issued April 8, 1987 the Commission responded to applications for rehearing by AT&T-C and U.S. Sprint, granting limited rehearing on the proper baseline for test year 1986 marketing expenses and correction of calculations for state and federal tax depreciation.

From the historical background discussed above, the following issues for Phase II were established, numerated, and announced as follows at the fourth prehearing conference (PHC) held for this proceeding on April 28, 1987:

1. The DRA staff Audit Report of July 31, 1986 and its March 27, 1987 Supplement,

2. The SNFA issue,

3. The correction of tax depreciation errors; and

4. The appropriateness of using 1985 versus 1984 as the base year for determining AT&T's test year 1986 marketing expense allowance.

Hearings on these issues were then scheduled for the summer of 1987 commencing on July 27, 1987. Twenty-one days of evidentiary hearings were held, 52 exhibits were received in evidence, and the official hearing transcript exceeded 2,150 pages at the conclusion of these Phase II hearings on October 21, 1987. Opening briefs were filed by AT&T-C, DRA, and TURN. Closing briefs were filed by AT&T-C and DRA whereas TURN opted to stand on its opening brief. Phase II was submitted upon receipt of closing briefs on December 31, 1987.

III. Stipulations

Prior to the first day of hearing DRA and AT&T-C reached consensus in two areas: the correction of errors in calculating state and federal tax depreciation, and SNFA. The parties also reached agreement on the appropriate amount of legal advertising expense to be included in corporate advertising.

1. Tax Depreciation Errors

In D.87-04-041 the Commission recognized an error in the calculation of tax depreciation expense and granted AT&T-C limited rehearing to, among other things, correct the amount on the record. While there was some initial confusion about the precise dollar amount in issue, DRA and AT&T-C subsequently stipulated to a $3.012 million figure on April 28, 1987, during the fourth PHC (Tr. 168).

Thereafter, on May 15, 1987, pursuant to the terms of D.87-04-041, AT&T-C filed Advice Letter 83 clearly stating that $3.012 million was the amount of annual revenue being sought; AT&T-C sought permission to recover the change in tax depreciation expense set forth in D.87-04-041, and to reduce its billing surcharge to 0.108%. The Commission by Resolution T-12032 dated June 24, 1987 adopted AT&T-C's Advice Letter 83.

2. Shared Network Facilities Arrangement (SNFA)

In Exhibit 199, Kevin P. Coughlan, DRA's then Project Manager in this proceeding, verified the reasonableness of the updated SNFA information provided by AT&T-C on September 25, 1986, which was incorporated in D.86-11-079.

Coughlan reached this conclusion after review of the workpapers submitted by AT&T-C. He acknowledged that:

> "The financial information provided in those workpapers appears to reflect the activities associated with facilities that AT&T-C leases to Pacific Bell. Another partial confirmation of AT&T-C's estimate is demonstrated by the fact that the revenues received by AT&T-C track with the lease expenses of Pacific Bell" (Ex. 199, p. KPC-1).

Coughlan, under cross-examination, concurred that SNFA effects embedded in AT&T-C's rates should be as authorized in D.86-11-079, with a slight modification to include an additional $0.52 million in AT&T-C's intrastate maintenance expenses set forth on pages 3 and 5 of D.87-04-041 issued April 8, 1987 in this proceeding (Tr. 5267-5268).

3. Legal Advertising Expense

On April 28, 1987 DRA's counsel stated that DRA was ready to agree with AT&T-C that the amount of $0.936 million for legal advertising should be added to the authorized expenses in this case (RT Vol. PHC-4, p. 167). This $0.936 million had been included primarily as part of staff's $3.8 million disallowance for corporate advertising because it was unaudited at the time. After review by the staff auditors DRA now recommends that this amount be added to the authorized expenses. AT&T-C concurs this $0.936 million figure is a total (unseparated) California expense item (RT Vol. PHC-4, p. 168).

IV. Reorganization

As part of its audit, DRA conducted an investigation of the major restructuring, reorganization, employee reductions, and plant consolidations that AT&T announced would take place in 1986.

According to AT&T-C this reorganization will continue into 1988 and perhaps beyond. DRA recommended that $3.5 million of the resulting savings be passed on to AT&T-C's total California operations for test year 1986.

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

DRA's Financial Examiner, Francis Fok, investigated the major reorganization of AT&T and determined that AT&T's staffing reductions actually began as early as 1984 and continued into 1986 (Ex. 201, pp. II-3 and II-4).

DRA contends that AT&T-C has shown no test year cost savings or increased expenses due to these major staff reductions throughout AT&T enterprises. DRA explained in its opening brief that AT&T Communications Companies and AT&T Information Systems (AT&TIS) reduced their forces by significant numbers of employees in 1984 and 1985. DRA went on to say that:

> "In 1985 and 1986, the FCC Computer Inquiry II decision to allow restructuring causes further AT&T staff changes. (FCC Docket 85-26) On January 1, 1986, all ATT-C federal government staff were moved to AT&T-Technologies (AT&T-T). In December, 1985, ten National Account marketing teams from AT&T Communications merged with AT&TIS staff on a trial basis. (Exh. 201, II-6)

> "Unrelated to Computer Inquiry II restructuring, numerous employees were transferred from AT&T Communications to AT&T Corporate Headquarters in 1985 and 1986. In September, 1985, 163 tax personnel in AT&T Communication's Central Finance Office were transferred to AT&T Headquarters. On January 1, 1986, the entire Public Relations department (approximately 350 employees), 91 internal auditors, and 150 Medical Department staff of AT&T Communications were transferred to AT&T Corporate Headquarters. In March, 1986, 147 security personnel were also transferred from AT&T-Communications to AT&T Corporate Headquarters. In the same month, 60-70 payroll development personnel were transferred to

AT&T-T from AT&T Communications. (Exh. 201, II-6 to 7.)

"Thus, AT&T Communications' workforce was reduced by over 2,600 employees prior to the implementation of the 1986 Reorganization Plan.

"On May 29, 1986, AT&T (parent) announced a major reorganization plan to merge AT&T Communications and AT&TIS into one organization. The plan was scheduled to begin September 1, 1986. (Exh. 201, II-3 to 4) AT&T planned to cut 10,900 (9%) management and 16,500 (8%) non-management employees in 1986. (Vol. 52, p. 6441-2)" (Staff Op. Br., p. 4.)

When asked by staff counsel, AT&T-C's controller, Maud E. Thiebaud, conceded that the main objective for this reorganization and merger was to cut costs to operate even more efficiently (Tr. 6440).

The staff had earlier asked if AT&T had monitored the 1984-1986 changes and evaluated the results and staff argues that AT&T had not done so, even though the joint marketing by the ten National Account teams was earmarked as "trial." Staff also contends that it asked if a reorganization analysis had been prepared before or during reorganization. No such plan was available, according to DRA (Ex. 201, II-7).

DRA argues that, in its petition requesting relief from the Federal Communications Commission (FCC) Computer II Structural Separation order in 1985, AT&T represented that operating costs of $1.1 billion to $1.7 billion could be saved by merging AT&TIS with AT&T Communications and eliminating duplicated resources. Total cost savings of $157 to $327 million were identified in the marketing and marketing facilities categories (Ex. 201, II-7 to 8).

DRA notes that on cross-examination, AT&T-C witness Thiebaud did not deny that the above-stated employee force reductions occurred in 1985 and 1986 (Vol. 51, pp. 6396-6399). Apparently, AT&T-C's estimated 1986 budget was based upon calculations that did not recognize these force count reductions (Vol. 62, 6401-3 and 6414). There was no dispute over whether these employee reductions occurred. The dispute was over the amount of cost savings attributable to AT&T Communications and thereby to AT&T-C in 1986 (DRA Op. Br., p. 5). According to DRA:

> "Since AT&T did not track cost savings or the impact of employee force count reductions, staff used the average savings in marketing and facilities for 1984 which had been estimated by AT&T in its FCC Structural Separation relief petition as a starting point to estimate cost savings. Staff estimated that 50 percent of these savings would go to AT&T Communications and 50% to AT&TIS. Staff added an inflation factor of 5.2% for 1985 and 3.5% for 1986. Staff allocated the amount of savings applicable to California operations for four months in 1986. This equates to a $3.8 million savings to AT&T-C (California) in 1986. (Exh. 201, II-8)" (DRA Op. Br., pp. 5 and 6.)

The $3.8 million savings for AT&T-C's total California operations was revised to $3.6 million in Exhibit 202 and corrected to $3.5 million in Exhibit 246-A.

In response to AT&T-C's rebuttal presentation of cost increases in 1986 due to reorganization, DRA pointed out that lump sum early retirement incentive payments resulting from special programs in 1986 would be amortized over a period, which would be five years under Internal Revenue Code, Section 248 (Vol. 41, p. 5394).

Staff then recommended that the following tracking of future reorganization impacts be ordered, since AT&T-C has no existing (or proposed) procedures:

> a. AT&T-C should provide the implementation plan including a schedule of staff changes, whenever this information becomes available;
>
> b. AT&T-C should track all costs associated with the reorganization plan, including employee relocation costs, by organization

and type identifying direct and shared costs;

c. AT&T-C should maintain monthly reports on costs tracked;

d. AT&T-C should identify the total effect of these costs in allocations to California;

e. AT&T-C should provide a final report upon completion of reorganization including the total economic impact. (Ex. 201, p. II-11 and DRA Op. Br., p. 6.)

DRA had initially recommended that any decision in this proceeding be subject to subsequently discovered effects of reorganization on the test year. However, staff witness Fok later agreed that rather than issuing another interim decision, it would be preferable to provide the reorganization impact report prior to the submission of the next rate case, similar to the Notice of Intent (NOI) procedure (Vol. 42, p. 5428) (DRA Op. Br., p. 6).

2. AT&T-C's Position

AT&T-C claims that no savings were achieved in the test year (1986) from corporate reorganization and employee reductions. AT&T-C argues that the reorganization adjustment, as proposed by DRA, is for cost savings allegedly realized in the final four months of 1986 as a result of the consolidation between AT&T Communications and AT&TIS authorized by the FCC.

AT&T-C argues that Fok noted that in 1984 AT&T had made a very broad estimate of savings that might ultimately be achieved through the FCC's elimination of the structural separation requirements set forth in its Second Computer Inquiry. While Fok agreed that the estimate used by AT&T in its FCC filing was "a potential range for cost savings" (Tr. 5378), he used that information to speculate that the consolidation of AT&T Communications and AT&TIS would occur effective September 1, 1986, and that AT&T would instantly start realizing all the cost savings predicted in 1984. However, AT&T-C contends that, based on more recent data, no savings were realized in the test year (1986) attributable to corporate reorganization (AT&T-C Op. Br., pp. 73 and 74).

AT&T-C calls attention to Thiebaud's testimony that the actions announced by AT&T in late 1986 involving major restructuring, employee downsizing, and plant consolidations would take place throughout AT&T to refocus business operating strategies to improve competitiveness and profitability by lowering the point at which revenues cover expenses. She further testified that the overall reorganization and force management were not limited to AT&T Communications and AT&TIS, but would in fact affect every AT&T entity and line of business. Additionally, she stated that "these activities are expected to continue through 1988, and perhaps beyond" (Ex. 229, p. 18) (AT&T-C Op. Br., p. 74).

AT&T-C then argues that full-scale consolidation of AT&T Communications and AT&TIS did not occur instantly, as Fok has presumed. Also, the effect of this overall AT&T reorganization was to increase costs in the test year with a very large charge to earnings.

AT&T then summarizes nearly seven pages of DRA witness Fok's cross-examination as concurrence that "AT&T quite probably did not achieve in 1986 the cost savings he had assumed." (AT&T-C Op. Br., p. 75.) AT&T-C urges the Commission to reject DRA's recommended adjustment.

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

DRA in its closing brief argued that at no time did Fok admit that 1986 cost savings would not be achieved. DRA explained that Fok testified that in 1986 alone, 5,000 employees were eliminated, as well as 10,900 management and 16,500 non-management positions. Fok could not distinguish these force reductions as outside of the announced "reorganization" from data submitted by AT&T-C. Fok agreed that cost savings may actually occur in the future; however, total reorganization expenses should be capitalized and amortized over a number of years in order to avoid inequity to current ratepayers paying the expense of employee incentive programs (DRA Cl. Br., p. 10).

4. Discussion

Neither AT&T-C nor DRA provided a complete record of the costs and savings which would result over time from the major ATT corporate reorganization undertaken in 1986. It is clear that DRA was not in a position to do so without extensive information from AT&T; it is equally apparent that this information was not available to DRA, for the purposes of preparing its audit report and the supplement thereto.

In setting rates for any given test year, we attempt to incorporate normalized expenses, so that substantial one time expenses do not unduly distort the revenue requirement. AT&T-C's position of neither asking for additional revenues nor providing information on cost savings to be achieved over time for this reorganization does not assist us in reaching a well-reasoned determination regarding the costs and benefits of this corporate reorganization.

We recognize that the real reason for this reorganization and force reduction is to cut costs and operate even more efficiently as was explained by Thiebaud (Tr. 6440). Without an overall study showing the costs and benefits of this reorganization over time, it is difficult for us to project ahead for the usual three-year rate-effectiveness period following a test year to present worth the future benefits over costs and spread those benefits appropriately over the three-year period.

Since we do not have this comprehensive showing, we will rely on the modest adjustment recommended by DRA ($3.5 million) as a proxy for the minimum savings on an annual basis which AT&T-C will achieve over time from its reorganization and force reduction.

In applying this $3.5 million amount, which DRA has incorporated for the test year, we are aware from DRA's testimony that this force reduction savings is largely associated with AT&T's overall marketing activities.

We have heretofore adopted less than AT&T-C's full Phase I request [of $156,633,000] for the marketing portion of the $200,856,000 marketing and advertising budget.

On this point we concur with AT&T-C that if the overall $3.5 million reorganization adjustment applies to its total California operations in 1986, then it is correct that we should proportionately reduce that adjustment for any adopted disallowance in the overall 1986 marketing budget, where it is accepted that the bulk of the reorganization savings developed by DRA will result. Otherwise, a double disallowance would likely result. Therefore, we will reduce DRA's proposed reorganization adjustment by the following proportion based on our confirmation of the Phase I marketing allowance of $104,230,000 for test year 1986 adopted elsewhere in this decision.

$$[\ (\$104{,}230{,}000 \div \$156{,}633{,}000) \times \$3{,}500{,}000\ ] = \$2{,}329{,}043$$ [2]

The adopted reorganization adjustment will therefore be $2.3 million on a total California basis using the normal rounding convention. The intrastate portion of this adjustment will accordingly be reduced to $1.0 million.

We will also adopt DRA's recommended record-keeping requirements relative to AT&T's major reorganization. In addition, similar records should be kept for any subsequent reorganizations which have an impact of over $100,000 on the overall operations of

2 Failure to make this calculation would have the effect of adopting a reorganization adjustment of about $5.3 million against AT&T-C's overall marketing budget or a $1.8 million greater adjustment than recommended by DRA.

AT&T-C or result in changes of over $100,000 in allocated costs to AT&T-C's California operations.

However, we will not require AT&T-C to submit these data until its next general rate proceeding, or in any future investigation into AT&T-C's rates which may be ordered by this Commission.

V. Billing and Collection System

In early 1984 AT&T began developing a multifaceted Customer Service and Billing Program, consisting of eight major business functions, described as follows:

> Account Inquiry--is a computerized data base system that contains an image of the customer records and billing entries for AT&T-C interexchange charges. When the company renders the customer bill, the billing records are provided to the Account Inquiry system. When the LECs render the bill, they provide AT&T-C with a copy of the AT&T-C portion of the bill and it is merged into the Account Inquiry system.
>
> Service Order Entry--is used by AT&T-C to create the records necessary to effect changes to customer accounts.
>
> Message Processing--provides for rating and assembling the usage records that are the basis for customer billing.
>
> Account Maintenance--retains the records of AT&T-C's customers names, addresses and other identifiers. This is the central data base for the other computerized systems for accessing information reflecting customer specific data.
>
> Credit and Collection--monitors accounts receivable and notifies AT&T-C representatives when amounts due are in jeopardy of being collected and establishes the extent of credit for customers.

AT&T-C or result in changes of over $100,000 in allocated costs to AT&T-C's California operations. The $100,000 level for tracking allocated costs or direct expenses to AT&T-C is consistent with the rounding practice used throughout Phases I and II of this proceeding. To require AT&T-C to report with finer detail would constitute an undue burden, and alternatively to require lesser records of AT&T-C's expenses and allocated costs would deny the Commission staff the opportunity for reasonable reviews of the utility's operations consistent with future auditing requirements.

However, we will not require AT&T-C to submit these data until its next general rate proceeding, or in any future investigation into AT&T-C's rates which may be ordered by this Commission.

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Credit and Collection--monitors accounts receivable and notifies AT&T-C representatives when amounts due are in jeopardy of being collected and establishes the extent of credit for customers.

> Message Investigation--supports the analysis of unbillable AT&T Communications calls, fraud cases and any errors found during the processing of message records.
>
> Bill Rendering--collects the computer processed data from the other systems, determines the amounts due from the customer, provides details of interexchange calls, applies appropriate taxes, surcharges and other items and prints the AT&T-C customer bill for mailing.
>
> Remittance Processing--creates account receivable update records based upon the amounts paid by AT&T-C's customers. It creates the bank deposits and reconciles the ledger entries for cash and accounts receivable. (Ex. 222, pp. 10-12.)

Some of these functions were in place and were used and useful in California during test year 1986, whereas others were to be phased in for use in subsequent years. The "used and useful" status of these various program functions to California ratepayers in test year 1986 became the subject of intense controversy in this proceeding.

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

DRA, at page 7 of its opening brief, acknowledges that this program was started by AT&T in April 1984 to develop and manage the corporate-wide servicing, management and billing of customer accounts which were performed by the local exchange companies (LEC) at divestiture. DRA then presented its understanding of the implementation schedule for the various program functions which included a 1985 AT&T pilot program in Minnesota to determine new credit and collection policies, and a 1986 test billing project in West Virginia. DRA stated that interstate private line services have been billed by AT&T Communications since 1984. However, intrastate private line customers were billed by local exchange companies in 1986. Separate billing for interstate WATS/800 was being done in five states, but not in California. DRA Financial Examiner James B. Simmons testified that AT&T-C indicated that none of these activities related to customer billing, other than account inquiry, would be operational in California before 1987. Account inquiry has been performed in California by AT&T-C since 1984. (Exh. 201, VIII-2.)

DRA then recommended that account inquiry costs be allowed, but that the remaining costs of approximately $79.1 million for AT&T-C's total California operations be capitalized due to the magnitude and future benefit of the expenditures. DRA also recommended that interest be earned on the capitalized amount. As portions of the billing system are implemented in California and concurrent charges from LECs are terminated, appropriate costs would be included in rate base and passed on to California ratepayers and other costs would be apportioned to AT&T Information Systems. DRA made no findings regarding the prudency of implementing this billing system. DRA recommended that such a finding be deferred until AT&T-C seeks to place the capitalized costs into rate base (DRA Op. Br., p. 7).

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

TURN argued that AT&T-C has not demonstrated the reasonableness of its billing and collection expenditures, and further review of these billing and collection procedures is appropriate. TURN recommends that this decision affirm the appropriateness of further review of billing and collection issues. TURN also argues that Resolution T-11049 and D.86-11-079 do <u>not</u> constitute approval of the utilities' billing and collection system, nor should they be read to prejudge such a reasonableness review. Both the resolution and the decision clearly were issued to assure prompt recognition of changed circumstances (reduced expenses for billing by Pacific Bell and rate changes for AT&T-C). Neither, argues TURN, contains a finding of fact that AT&T's investments in its new billing and collection system are reasonable, as AT&T-C seems to infer. TURN believes that a prudency review of AT&T's billing and collection system is also appropriate from the standpoint that it will duplicate the services of Pacific Bell and the other LECs.

3. <u>AT&T-C's Position</u>

AT&T-C argues that direct expensing of all development and deployment costs for its customer service and billing system is reasonable.

AT&T-C contends that in permitting joint billing by the Bell Operating Companies of customers subscribing to both their own services and those of AT&T, the Modified Final Judgment presumed that the amount AT&T would be required to pay the Bell Operating Companies for billing services "would presumably be less than that required if AT&T were to provide its own billing." On that presumption, the court declined to require AT&T to develop its own billing capability and permitted continuation of the performance of combined billing services.

During 1983, as the Bell Operating Companies filed proposed access and billing tariffs throughout the nation, it soon became obvious to AT&T that it was not going to receive the anticipated benefits of cost-based pricing for billing services. Rather, the prevailing tendency was to extract profits from their billing services that far exceeded authorized levels of return. AT&T-C determined that the rates adopted in D.83-12-024 for Pacific Bell relative to A/83-06-65 resulted in 186% and 201% return on Pacific Bell's billing services. AT&T-C's witness Connolly testified that it was apparent to AT&T that the LECs had little incentive to restrain the prices they would charge for billing and collection services (Ex. 222, p. 7). Therefore, AT&T undertook a thorough analysis of the alternatives to perpetual reliance on the LECs for billing services. AT&T-C argues that over a six-year study period its own billing system would cost 23% less than the anticipated costs of LEC billing and collection services.

On the question of which customer service and billing functions were used and useful during test year 1986, AT&T-C cited Connolly's testimony:

> "...that all of the systems described earlier in my testimony were functioning in 1986 for California customers, with the billing and message processing operations on line only for interstate services." (Ex. 222, p. 17.)

AT&T-C also contends that:

> "The Company implemented its own billing of interstate WATS and 800 accounts in other states in 1985 and converted its interstate WATS and 800 accounts in California in early 1986. Accordingly, the message processing, credit and collection, bill rendering and remittance processing functions were also used and useful for AT&T customers in California during the test year [for these particular accounts]." (AT&T-C Op. Br., p. 36.)

In late-filed Exhibit 250, AT&T-C summarized its deployment of Customer Service and Billing Program functions in California, as follows:

Function	Service Category	Service Date	California In-Service Date
Account Inquiry	WATS/800	1/84	6/84
	Private Line	1/84	1/84
	MTS	1/84	6/84
Service Order Entry	WATS/800	1/84	1/84
	Private Line	1/84	1/84
	MTS	1/84	9/84
Message Processing	WATS/800	2/85	2/86
	Private Line	N/A	N/A
	MTS	6/87	6/88
Account Maintenance	WATS/800	1/84	1/84
	Private Line	1/84	1/84
	MTS	1/84	9/84
Credit & Collection	WATS/800	2/85	2/86
	Private Line	1/84	1/84
	MTS	9/85	6/88
Message Investigation	WATS/800	1/84	1/84
	Private Line	N/A	N/A
	MTS	1/84	1/84
Bill Rendering	WATS/800	2/85	2/86
	Private Line	1/84	1/84
	MTS	6/87	6/88
Remittance Processing	WATS/800	2/85	2/86
	Private Line	1/84	1/84
	MTS	6/87	6/88

NOTE: MTS stands for Message Telecommunications Service, or toll service. The service is marketed as AT&T Long Distance Service.

AT&T-C then described how California customers were being provided these services from work centers both inside and out of California (Ex. 222, p. 13 and Tab. 3, pp. 31-38).

On expensing versus capitalization of the costs of developing the billing program, AT&T-C's controller Maud E. Thiebaud testified that because of the indeterminant service life of the billing system and its dynamic character, the company's treatment of these costs as current period expenses is required under generally accepted accounting procedures (Ex. 229, p. 4).

AT&T-C's witness Lawrence Gotfried, a partner in the firm of Coopers and Lybrand, concurred with Thiebaud on the expensing of the developmental costs of the billing and collection system.[3]

AT&T-C contends that the record does not support DRA's argument that AT&T-C's provision of customer service and billing functions duplicate those paid to the LECs. AT&T-C refers to Connolly's testimony (at Tr. 6107) that it has discontinued the use of customer service and billing functions from LECs when it deployed its own system to accomplish those functions. Accordingly, AT&T-C claims that neither it nor its customers are doubly charged for performance of customer service and billing activities.

AT&T-C further contends that the two DRA alternatives shown in Exhibit 251 both assume deferred recovery of all intrastate expenses for the organizational units which were performing development work. AT&T-C argues that these activities should be expensed as incurred, and accordingly even the $5.7 million intrastate adjustment would result in an inappropriate deferral of expenses.

AT&T-C concludes that its 1986 test year expenses for customer service and billing functions should be adopted in full. If a limited deferral of recovery of some of AT&T's reasonably incurred expenses is deemed appropriate, it asserts that no more than $5.7 million should be deferred with interest, and the Commission should allow AT&T to recover that amount by a compliance filing immediately upon the commencement of AT&T-C's direct intrastate toll billing (AT&T-C Cl. Br., p. 9).

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3 On cross-examination by staff counsel he agreed that it was up to the Commission to decide [whether to expense or capitalize these costs] (Tr. 6217).

4. <u>Discussion</u>

It is clear from the extensive testimony, exhibits, and briefs, that the parties are widely separated in their positions regarding what functions of the customer service and billing system were used and useful to AT&T-C's California ratepayers in the test year (1986). DRA would have us disallow all activities and functions except for the account inquiry function, resulting in a total California operations expense adjustment of $79.1 million and a disallowance of intrastate expenses of $20.1 million.

This position is untenable. When the Commission issued Resolution T-11049 on June 25, 1986 authorizing a reduction of Pacific Bell's charges to AT&T-C in July 1986 for billing and collection services, AT&T-C had either already undertaken, or would soon begin doing, some of the work previously performed for it by Pacific Bell. The resolution even narrated the fact that: "in February 1986, AT&T-C took back its interstate WATS/800 traffic billing" and stated its intention to take back most of its billing functions.

Therefore, at least 30 days prior to the issuance of its July 31, 1986 audit report DRA was, or should have been, aware of reduced activities and charges from Pacific Bell to AT&T-C, with such activities being absorbed by AT&T-C with at least some increases in its own expenses.

On the other hand, AT&T-C's position of having California ratepayers pick up all developmental and ongoing expenses for its customer service and billing functions during test year 1986 is equally insupportable. This position would not be reasonable unless AT&T-C had fully absorbed <u>all</u> program functions including the direct rendering of approximately 10 million customer bills each month. This will involve the stuffing, adding postage, and mailing of these 10 million envelopes to customers each month and then, receiving and processing about 10 million customer payments each month.

On January 13, 1988, the Commission issued an Order Instituting Investigation (I.) 88-01-007 which will investigate AT&T's plan to directly bill its interstate and interLATA business and residence toll telecommunications message services in California on or after June 1988.

This OII is the appropriate forum for determining the reasonableness of AT&T-C's plan and costs to directly bill its customers for interstate and interLATA message toll service. Deferred developmental and other costs, carried forward from this proceeding, should be considered in a future rate proceeding after the AT&T-C take-back occurs. Meanwhile, by deferring a specific amount in an interest-bearing account from the date of this decision as AT&T-C suggests the results of operation for test year 1986 may be finalized and this general rate proceeding concluded.

We will authorize AT&T-C to place $9.1 million of the California intrastate expenses, so allocated from AT&T's development and deployment of its Customer Service and Billing Program, into an interest-bearing memorandum account to accrue interest at the average three-month commercial paper rate as published in the Federal Reserve Bulletin.

This action recognizes that AT&T-C did, according to the record in this proceeding, deploy some portions but not all of its Customer Service and Billing Program for its California operations in test year 1986.

This treatment further recognizes that AT&T did <u>not</u> make a full, timely, and complete showing of which program functions were deployed as used and useful during the test year for its California operations and also recognizes that the major billing and collection function for its residence and business message toll service remained with the LECs during the test year (1986).

Based on the treatment of these expenses there is no need to deal with issues of deferred capitalization or rate-basing the costs for AT&T-C's Customer Service and Billing Program in test

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The specific amount to be deferred is $9.1 million. This is the amount that DRA witness Simmons developed from Exhibit 209, Appendix A, in response to the assigned ALJ's request that DRA give some consideration to the fact that AT&T-C's witnesses Connolly and Thiebaud had testified that certain Customer Service and Billing program elements were in place in California in 1986.

In response to comments by AT&T-C that it would calculate this amount differently and arrive at a much lower deferral, DRA in its June 8, 1988 "Late-Filed Reply Comments" explained that it found no error in its calculation of the $9.1 million deferral, and, "...The 9.1 million [deferral] in billing and collection expenses was calculated using this Commission definition of used and useful facilities."

We will authorize AT&T-C to place $9.1 million of the California intrastate expenses, so allocated from AT&T's development and deployment of its Customer Service and Billing Program, into an interest-bearing memorandum account to accrue interest at the average three-month commercial paper rate as published in the Federal Reserve Bulletin.

year 1986. The unadjusted amounts will be included as test year 1986 operating expenses and the $9.1 million adjusted amount will accrue interest as specified above until further order of the Commission.

We will find that those customer service and billing program functions which were fully implemented, used and useful and not duplicated by the LECs during test year 1986, as previously described, were developed and deployed in a reasonable and prudent manner by AT&T-C.

The determination of prudency of AT&T-C's take-back of its message billing service from the LECs and its own introduction of direct billing will be determined in a future proceeding.

VI. Corporate Headquarters

AT&T-CH provides the AT&T Communications companies with advice and assistance in public relations, public affairs, legal, planning and financial management, accounting and treasury matters. AT&T-CH's functions also include AT&T's Executive Department and Corporate Secretary.

The decision in Phase I (D.86-11-079) reviewed, in some detail, AT&T-CH's operations and costs. It was AT&T's position that these functions were necessary and cost-effective, since otherwise the AT&T Communications, Inc. [also known as the National Operations and Management Company (NOMC)][4] would have to perform this work and bear the full costs, instead of an allocated portion. As explained in D.86-11-079 expenses for functions performed within AT&T Communications can be defined in three ways:

1. Directly incurred (such as operators' wages or access charges).

4 See the Summary of Decision section of this order for further details of AT&T's organizational structure.

This action recognizes that AT&T-C did, according to the record in this proceeding, deploy some portions but not all of its Customer Service and Billing Program for its California operations in test year 1986.

This treatment further recognizes that AT&T did not make a full, timely, and complete showing of which program functions were deployed as used and useful during the test year for its California operations and also recognizes that the major billing and collection function for its residence and business message toll service remained with the LECs during the test year (1986).

Based on the treatment of these expenses there is no need to deal with issues of deferred capitalization or rate-basing the costs for AT&T-C's Customer Service and Billing Program in test year 1986. The unadjusted amounts will be included as test year 1986 operating expenses and the $9.1 million adjusted amount will accrue interest as specified above until further order of the Commission.

This reduced deferral of $9.1 million, contrasted with the $20.1 million disallowance recommended by DRA, recognizes that certain customer service and billing program functions were at least partially implemented, used and useful and not duplicated by the LECs during test year 1986, as previously described. However, we are also persuaded by DRA's May 31, 1988 comments that late-filed Exhibit 250 was not tested and verified and thus cannot be used to determine the prudency of AT&T-C's take-back of its billing and collection service.

The determination of prudency of AT&T-C's take-back of its message billing service from the LECs and its own introduction of direct billing will be determined in a future proceeding.

2. Directly assigned (such as identifiable expenses which benefit operations in a limited group of states).

3. Functionally allocated (all remaining expenses which benefit all jurisdictions and cannot be directly or uniquely assigned).

Functionally allocated expenses are distributed to jurisdictional entities such as AT&T-C, based upon several factors including average investment, revenues, and composites of several factors.

In Phase I DRA auditors had not completed their review of the corporate headquarters or NOMC expenses. DRA was not satisfied at that time that these expenses primarily benefited California ratepayers or the shareholders or individual users of the AT&T products or services. DRA contends that expenses should be allocated to the party who benefits from them, citing price Commission precedents [(PT&T: License Contract) (1979) in 1 CPUC 2d 488, 574-575; (AT&T-C's 1984 test year proceeding) [D.84-06-111, pp. 97-113 (mimeo.)]. In D.85-03-056, the further opinion on AT&T-C's 1984 revenue requirement, we strongly supported a staff audit of AT&T expressly to allow DRA to determine the reasonableness of expenses being charged to California operations by AT&T-CH and NOMC. In Phase I, of this proceeding, with its audit in progress but not completed, DRA requested that $15.1 million ($5.8 million on an intrastate basis) be withheld from approval until completion of its audit. The basis for DRA's request was set forth in the Phase I testimony of witness Thomas Lew as follows:

1. General lack of sufficient detail, audit trail, and/or readily available information to reasonably ascertain what types of projects the national organization has been involved in.

2. Many data responses have generally been responded to [in] an incomplete manner,

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>
> 2. Many data responses have generally been responded to [in] an incomplete manner,

notably lacking sufficient detail to be responsive.

3. Some requested information has not been made available at all.

4. Completion time for data responses has generally been inordinately lengthy.

5. Evolving changes in accounting systems has made interyear comparability a very difficult process. (Ex. 100, Appendix 9-A, p. 4.)

DRA's primary concern was with $450.7 million of costs incurred nationally and then allocated or assigned to California from AT&T-CH and NOMC. These, argued DRA, were the same categories of expenses and allocation methods that were in dispute between AT&T-C and staff in 1984. DRA contended that the $5.8 million Phase I hold-back on an intrastate basis simply provided that the 1984 disallowances would be maintained until its audit was complete [D.86-11-079, pp. 52-54 (mimeo.)].

AT&T-C argued in Phase I that DRA's proposed adjustments were nothing more than mechanical continuations of previous 1984 disallowances and that these adjustments are no longer appropriate following divestiture (D.86-11-079, mimeo. p. 54).

With these arguments before us in Phase I of this proceeding we faced two choices: to identify these dollars ($15.1 million or $5.8 million on an intrastate basis), and designate them as a portion of AT&T-C's 1986 revenue requirement, subject to refund at the conclusion of the Phase II proceeding, or to withhold the amount pending completion of the staff audit and hearings thereon. Without the benefit of a completed staff audit we chose the second option and withheld $5.754 million on an intrastate basis until completion of Phase II (D.86-11-079, pp. 57-58 and 2).

The $5.8 million intrastate hold-back of Phase I represented staff adjustments for certain affiliated transactions in addition to the AT&T-CH and NOMC adjustments, which we will now address in this part of the order. The adjustments for affiliated transactions are addressed separately in this order.

1. Position of DRA in Phase II

DRA explains that AT&T-CH bills AT&T Communications (nationwide) (also referred to as NOMC), which in turn bills AT&T-C for certain services. DRA's audit first addressed the basic functional activities performed at the corporate level and made specific recommendations for disallowances of those activities and services that were not considered as benefiting AT&T-C's California ratepayers; DRA then addressed separately the methods used by AT&T-CH and NOMC to allocate the remaining unadjusted expenses to AT&T-C.

DRA further explains that its audit included a review of all AT&T departmental functions as described in Budget Decision Packages (BDP's) and interviews of representatives of each AT&T department. Descriptions of the functions of AT&T's General Departments in 1982 (predivestiture) were compared with 1984 descriptions. DRA contends that it found the holding company functions of these departments in 1986 to be the same as those noted in the last license contract review in 1984.

After this review, staff aggregated the actual expenses into groups of costs with common allocation bases and allocated them as follows:

- Activities which do not provide any direct benefit to AT&T Communications, which are duplicative of work performed by AT&T Communications, and/or which would not be necessary if AT&T Communications were a stand-alone company. These costs were excluded;

- Directly assignable costs were allocated to the relevant entities;

- Activities which exhibited a casual relationship to a measurement base were allocated using that base;

- Activities which benefited each line of business equally and which required the same amount of time to perform for each entity were allocated equally to all lines of business.
  (Ex. 201, IX-4 and staff Op. Br., pp. 17-19.)

DRA states that, historically, this Commission has disallowed investor-related expenses which are primarily incurred for the benefit of a holding company, such as AT&T. (D.90362, D.93367, and D.84-06-111.) DRA auditors reviewed the minor additional functions which have been added since divestiture according to these Commission standards. No disallowances were recommended for preparation of annual reports to stockholders, even though these expenses were disallowed in the past. Prior to divestiture, both PT&T and AT&T issued stock and prepared annual reports to stockholders. Only one expenditure for these dual activities was allowed. AT&T-C, unlike its predecessor, PT&T, does not issue its own stock, and therefore, prepares no stockholder reports. Since there was no longer a duplication of expense, DRA allowed the expense for preparing AT&T's annual stockholder reports. However, DRA recommended reductions in total allocated expenses where the functions of AT&T duplicated those of AT&T-C did not benefit California ratepayers, and were allocated under improper methods. DRA also recommended that different allocation methods be adopted based upon Commission precedents (Ex. 201, p. IX-C-1, Revision III and DRA Op. Br., p. 19).

In its opening brief DRA provided an analysis and recommendation for each AT&T-CH department activity as discussed below:

a. <u>Executive Department</u>

This includes the Office of the Chairman of AT&T and immediate support organizations which provide executive policy and guidance for all AT&T entities. Staff noted that the dissemination of corporate information, previously performed by the Executive

Department, had been moved to the Employee Information/Public Relations Department of AT&T.

In previous cases, Executive Department allocations were cut by 61% to remove expenses for investor-related activities. The remaining expenses were allocated as overhead for these same functions.

AT&T Communications has its own Executive Department and Board of Directors. Policy and guidance of AT&T Communications is performed by AT&T Communications personnel. Expenses from AT&T for the same activities are duplicative and are primarily for the benefit of AT&T, the holding company. DRA recommends the same 61% reduction of these allocated expenses and allocation of remaining expenses as overhead (Ex. 201, IX-6, DRA Op. Br. p. 20).

b. <u>Corporate Secretary</u>

The Corporate Secretary Department includes the office of the Corporate Vice President and Secretary. It provides support to the AT&T Board of Directors, is responsible for shareowner relations programs, and keeps all corporate records. This department performs the same functions as the predivestiture Secretary Department. In the past, this Commission disallowed 100% of these allocated expenses. However, since divestiture, AT&T Communications does not perform these functions, which are primarily required by law. Therefore, DRA recommends no adjustment for these AT&T allocated expenses (Ex. 201, IX-7).

c. <u>Employee Information/Public Relations</u>

DRA claims that this AT&T department provides national advertising, underwrites public television broadcasts, coordinates entity advertising and employee information and communications programs, administers charitable contributions, and maintains corporate archives.

DRA argues that in prior decisions, the Commission disallowed 100% of these expenses on the basis that they were investor-related and primarily aimed at enhancing the corporate image.

In 1986, public relations functions were transferred to AT&T from all of its entities. This involved the transfer of approximately 350 personnel from AT&T Communications alone. It is reasonable, in DRA's view, to expect cost savings due to this consolidation. However, AT&T asserts that this consolidation was designed to increase efficiency and that it is not possible to quantify cost savings (Ex. 201, IX-8).

DRA found that the functions of this department in 1986 were the same as in 1984, with the additional duty of preparing AT&T Annual and Quarterly Reports to shareholders. DRA allowed all of the latter expenses. DRA recommends that 50% of employee information and communications expenses be allowed because there is some general benefit of this service to AT&T Communications' employees. DRA argues that the remaining expenses, which are 97.85%, relate to investor interests and should be disallowed (Tr. 5347 and Ex. 301, IX-10).

d. <u>Public Affairs</u>

DRA explained that this department coordinates governmental matters, including the representation of AT&T enterprises before Congress, state legislatures, the executive branch, and other non-regulatory agencies. The functions in 1986 were the same as 1984.

Traditionally, this Commission does not allow expenses for legislative advocacy, which are deemed to be investor-related. However, expenses for monitoring and disseminating information of legislative activity are allowed.

In 1986, AT&T allocated both legislative advocacy expenses and expenses for monitoring and disseminating legislative information. However, AT&T Communications' External Affairs Department also gathers legislative information and prepares positions on legislation. These expenses duplicate those of

AT&T-CH. DRA disallowed 50% of this department's expenses based upon unallowable legislative advocacy and duplication of AT&T Communications' functions (Ex. 201, IX-11 and DRA Op. Br., p. 21).

e. Legal Department

DRA asserts that this department provides periodic legal counsel. It also coordinates all antitrust litigation, although AT&T Communications may perform the staff work. DRA's adjustments were based upon the method of allocation, rather than the appropriateness of total costs allocated.

After aggregating legal expenses, staff allocated some expenses based upon the type of legal activity involved. For example, expenses for legal advice relating to personnel were allocated based on the number of employees. Expenses for legal advice solely related to unregulated entities were excluded. Antitrust expenses were addressed in Phase I of this proceeding. The remaining expenses for ongoing, general legal advice and representation were allocated equally to all lines of businesses (Ex. 201, IX-13 and DRA Op. Br., p. 22).

f. Human Resources, Personnel Management Pension Services, Labor Relations

This department establishes AT&T's personnel policies, coordinates all entities' personnel and labor relations policies, and coordinates bargaining efforts on common issues. In past cases, these expenses were allocated as overhead. DRA allocated these expenses as overhead (Ex. 210, IX-14 and DRA Op. Br., p. 22).

g. Finance Department

This department provides financial management services, including capital acquisition and cash management. Specific activities include financial planning, pension and savings plan management, cash management, banking methods advice, investor relations guidance, and AT&T security financing services. These activities were the same as those performed by the former Treasury

Department and Planning and Administration Division of the old General Department. DRA claims that, in previous cases, most of these expenses were disallowed as investor-related activities.

DRA reevaluated the 1986 activities and excluded 100% of the expenses relating to the following activities which do not benefit the California ratepayer:

- Joint ventures, mergers, acquisitions;
- Expenses carried over from the previous year.
- Pool of Funds and Temporary Cash Investments (AT&T surplus cash accounts used for interest-bearing cash advances to all entities);
- AT&T Foundation, a charitable organization;
- Institutional investor relations to maximize the price of AT&T stock.

DRA auditors then identified those functions which should be directly allocated using a specific base. The costs for AT&T's Stock Sale Program and Commercial Paper projects were allocated using capital requirement. The costs of servicing AT&T securities by American Transtech, Inc. were allocated using investment. DRA then allocated the remaining expenses equally to all lines of business on the premise that these functions benefit all entities equally (Ex. 201, IX-15 to 16 and DRA Op. Br., P. 23).

h. Financial Reports, Tax Reporting, Other Chief Financial Officer Functions

This department provides accounting services, coordinates AT&T business plans and budgets, establishes corporate tax policy and prepares consolidated tax returns. Its functions were the same as the predivestiture Comptroller and Planning and Administration Departments. The portion of the comptroller expenses relating to the preparation of Bell System Reports was totally disallowed in prior cases.

DRA asserts that in 1986, 163 tax personnel were transferred to AT&T-CH from AT&T Communications. Tax employees were also transferred from other entities. In 1986, 238 internal auditing and security personnel were transferred from AT&T Communications to AT&T and additional personnel were transferred to AT&T-CH from other entities as well. DRA argues that it would be reasonable to expect that such a large consolidation would result in efficiency gains. However, AT&T showed no cost savings due to this staff consolidation.

DRA excluded expenses unrelated to AT&T Communications, directly allocated expenses solely related to that entity and equally allocated the majority of the remaining expenses (Ex. 201, IX-17 to 18 and DRA Op. Br., pp. 23 and 24).

i. <u>Corporate Strategy and Development</u>

This department provides strategic planning, merger, acquisition and joint venture development, and diversification. This department performs the same functions as the General Planning and Corporate Matters Division of the predivestiture General Department. In previous cases 100% of these expenses were disallowed. DRA recommends the same treatment in 1986 on the basis that it serves only corporate interests, performs investor interest activities, and is entirely duplicative of functions performed at the entity level (Ex. 201, IX-19 and DRA Op. Br., p. 24).

j. <u>Federal Regulation</u>

This department represents AT&T before the FCC. Most of this department's activities relate to the interstate operations, formerly called the "Long Lines Division." DRA explains that it separated these expenses primarily to the interstate jurisdiction (Ex. 201, IX-20 and DRA Op. Br., p. 24).

k. <u>Industry Matters</u>

This department oversees all AT&T entities' efforts in governmental and industry-related actions. DRA contends that this department provides lobbying support and interfaces with the Public Affairs, Public Relations and Federal Regulatory Matters Departments.

In 1985, this department was divided and consolidated with the Public Affairs, Public Relations and Federal Regulatory Matters Departments. AT&T Communications has its own External Affairs Department which analyzes legislation and develops position statements. DRA determined that this department performs a mixture of allowable and disallowable activities and duplicates AT&T Communications' activities; therefore, it recommends a 50% disallowance of these expenses (DRA Op. Br., pp. 24 and 25).

2. <u>Position of AT&T-C</u>

AT&T-C believes that AT&T-CH provides essential home office management functions for AT&T-C and other AT&T affiliated companies. The costs incurred by AT&T-CH are allocated using a composite allocator which includes assets, revenues, expenses, and employee count.

AT&T-C witness Richard B. Troxel, a partner in the firm of Peat, Marwick, Main & Company, testified in Phase I, that these centralized services were beneficial, and not duplicative of functions performed by AT&T Communications. Troxel also contended that the relative number of employees involved in providing home office services was the lowest number of central service employees of all of the companies surveyed as a percentage of sales or overall employees. Troxel opined that AT&T's composite allocations method was reasonable, efficient, and appropriate (AT&T-C Op. Br., pp. 107 and 108).

AT&T-C notes that in Phase II DRA has recommended a ratemaking adjustment to test year AT&T-CH expense of approximately $7.1 million [$9.4 million less $2.3 million for gain on sale of

195 Broadway which is dealt with separately herein] on an AT&T Communications' total California basis (Ex. 201, Ex. 239). The greatest part (approximately two-thirds) of DRA's recommendation is comprised of proposed disallowances in national expenses for functional activities performed at AT&T-CH (Ex. 236, Attachment C, p. 6). AT&T-C contends that the general rationale supporting these proposals is that the Commission made similar disallowances, often in the exact percentage, in predivestiture Bell System License Contract decisions relating to the expense of AT&T's former General Departments. AT&T-C argues that the other portion of DRA's overall proposed adjustment to 1986 AT&T-CH expense is comprised of various reallocations, caused by the subjective use in different circumstances of single-factor allocators, an "equal to all lines of business" allocator, and the redesignation of functional expense as "overhead." Some of these recommendations are based on predivestiture cases; the "equal to all" allocator is based on the limited use of that concept in a recent Pacific Bell case; and other proposals appear to be newly invented (AT&T-C Op. Br., pp. 108-109).

AT&T-C disagrees with what it calls DRA's essentially predivestiture mechanical determinations [disallowances] in this proceeding.

AT&T-C presented the testimony of its Vice President of Regulatory Matters, Robert B. Stechert, and AT&T-CH's District Manager from its Chief Financial Office Department, Conrad J. Ankiel, who contended that post-divestiture circumstances in the test year are different from those prevailing in the Bell System era.

AT&T-C states that, consistent with competitive market conditions and the reduced scale of management activities, AT&T-CH's work force was only about 14% of the size of its predecessor organization after divestiture (Ex. 214 and AT&T-C Op. Br., p. 109).

AT&T-C argues that the Commission should adopt AT&T-CH expenses as reasonable and reject DRA's adjustments which it alleges relied on outdated prior determinations.

AT&T-C also argues that the Commission should reject DRA's attempt to revamp what it believes is AT&T's reasonable and consistent allocation of AT&T-CH expense. It contends that DRA's proposed substitute allocations are inequitable, arbitrary, inconsistent with generally accepted cost accounting standards and not required by prior Commission decisions (AT&T-C Op. Br., p. 109).

3. Discussion of Corporate Headquarters Adjustments

While it is true that the overall organization of AT&T as a corporation has changed significantly as it assumed its post-divestiture structure, and that it has reduced its headquarters staff significantly, it is not true that the specific corporate headquarters functions[5] which were long considered as investor-related have changed sufficiently to be regarded now as directly ratepayer-related.

AT&T witness Ankiel presented a listing and description of corporate headquarters functional activities recommended for disallowance by DRA. Ankiel's descriptions[6] of the DRA disallowed headquarters functional activities confirm that these activities are generally related to non-utility corporate interests

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5 Before we address a basic review of the DRA staff adjustments for post-divestiture AT&T-CH operations, it is important to note that DRA also proposes a new "equal to all" allocations method which would result in further reduced allocated costs to AT&T-C for allowable corporate headquarters expenses. This new allocations method and the reasonableness of its use for test year 1986 will be addressed later herein.

6 A comprehensive listing of the specific activities identified by Ankiel as being associated with DRA disallowances is set forth in Appendix A to this order.

or performed for the benefit of investors, rather than AT&T-C's utility ratepayers.

First, with reference to all proposed DRA AT&T-CH disallowances that involve expenditures for any form of corporate advertising, those disallowances were laid to rest with the adoption of the overall advertising budget for AT&T-C in D.86-11-079, and are not being reconsidered here.

Next, on the question of Public Relations and Employee Information activities, AT&T-C has advanced certain arguments which are worthy of our further consideration as to the need, in the test year, to allow a portion of the overall AT&T Communications (NOMC) public relations expenses. These allowances are not intended to establish new precedents for the future, but do appear to be necessary and reasonable during the test year to help inform employees and consumers, on a consistent basis, of the services which continue to be available from the post-divestiture AT&T-C. This information is considered vital until the public is settled in its selection of an interexchange carrier (IEC) of choice. We will review these necessary test year 1986 public relations functions under the next section of this order dealing with AT&T Communications National Operations and Management Corporation (NOMC).

However, when we address the DRA's recommended disallowances for corporate public relations activities at AT&T-CH as identified by Ankiel, we again see the types of public relations functions and activities which we have long regarded as investor-related. Perhaps, the clearest examples, apart from the advertising examples, are exhibits for special corporate events, underwriting "The MacNeil/Lehrer NewsHour" and the sponsorship of a quality arts program.

For example, AT&T contributed nearly $4.8 million, on a nationwide basis, for the underwriting of "The MacNeil/Lehrer NewsHour," program in 1986 (Ex. 236, Attachment C, Sheet 3 of 6).

It is quite proper for a Public Broadcast viewer to voluntarily contribute to support the Public Television Station that airs this program. However, it is an entirely different matter to ask that the AT&T-C customer contribute to the development and airing of that program, on an involuntary basis, through his/her interLATA telephone bill. The same is true of the other DRA recommended adjustments for corporate public relations activities and functions which include a wide range of cultural, education, charitable and corporate identity programs. Therefore, we will generally adopt DRA's position on AT&T-CH's public relations activities disallowance, except as discussed further under the AT&T Communications (NOMC) section of this order.

A review of Ankiel's AT&T-CH legal activity descriptions reveals that these DRA disallowed services are clearly investor-related, dealing with acquisitions, mergers, and/or joint ventures. DRA did not exclude legal services for ongoing, general legal advice and representation as discussed earlier. We will adopt DRA's partial adjustment of AT&T-CH's legal department activities for investor-related functions.

The portion of AT&T-CH's corporate finance and accounting functions, which deals with temporary investments, strategic and operational tax planning, AT&T data systems activities, financial analysis, AT&T consolidated business planning, investor and financial community contacts, internal audits, joint venture/merger acquisition activities, corporate financing, and administration of AT&T Foundation, recommended for disallowance by DRA, as described by Ankiel, is again clearly investor-related. Therefore, we will adopt DRA's partial adjustment for the investor-related portions of these Financing and Accounting functions.

Lastly, Ankiel's description of AT&T-CH's Corporate Strategy and Development functional activities underscores DRA's point that the activities serve corporate interests only. We have routinely disallowed 100% of the expenses for these activities in the past, as being exclusively corporate and investor interest-related. We will again adopt these same adjustments.

DRA has recommended an adjustment of $7.1 million for AT&T-CH's overall services allocated to total California operations, which would result in a disallowance of $2.8 million on AT&T-C's California intrastate operations. However, since we are not adopting DRA's equal-to-all allocations method for test year 1986, as will be discussed next, the adopted adjustments to AT&T-C's expenses allocated to AT&T-C are reduced to $4.6 million for its total California operations and $1.8 million for its intrastate operations for test year 1986.

4. DRA's New Equal-to-All Allocations Method

In this proceeding, in addition to performing the long-standing adjustments for investor and holding company functions and activities, DRA has proposed that we allocate certain of the remaining allowable expenses on an equal-to-all lines of business basis, to which AT&T-C strenuously objects. DRA applied this new allocation method to the adjusted (allowable) expenses of the following corporate headquarters departments:

- Legal
- Finance
- Financial Reports, Tax Reporting, and Chief Financial Officer

DRA believes that it is proper to use this new method of allocating corporate expenses wherever the benefit of a given service appears to be of equal value to all lines of business, and the expenses are not otherwise directly assignable. An example of an expense which would best fit this description is the preparation of AT&T's Corporate Consolidated Federal Income Tax return by assembling the contents of all of the "Separate Federal Income Tax" returns of the affiliated and subsidiary companies. The work of combining these

"Separate" returns into a "Consolidated" return appears to be of equal value to all affiliated and subsidiary companies. Therefore, DRA's proposed "equal-to-all" allocations method would be reasonable and proper for this and similar home office expenses, that benefit all lines of business equally.

Unfortunately, its application and adoption in this proceeding would not be consistent on a rate-fixing basis with the allocations methods utilized by other state regulatory commissions or the FCC. We have heretofore adopted DRA's new equal-to-all lines of business allocation method in D.86-01-026 issued January 10, 1986 for Pacific Bell's test year 1986 rate proceeding (Finding 14, mimeo. p. 207).

However, Pacific Bell's utility telephone service is, for the most part, provided wholly within California and on a local exchange and intraLATA basis is subject to the regulatory authority of this Commission.

Therefore, while DRA's equal-to-all lines of business allocation method has great merit, we will not adopt this allocation method for determination of AT&T-C's 1986 results of operation.

We will, however, encourage AT&T-C to consider the future use of this method, where other direct allocations methods are not possible and where equal benefit to all lines of business exists. In so doing, we will also place AT&T-C on notice that there will be a further opportunity for DRA again to present evidence and arguments for the adoption of this allocation method in any future AT&T-C general rate proceeding or rate investigation.

We also encourage DRA to further advance discussions regarding the use of this allocation method in its regular conferences on utility accounting practices involving other regulatory agencies throughout the nation, and through its membership on the National Association of Regulatory Utility Commissioners (NARUC) Staff Subcommittee on Accounts.

5. DRA's Recommended Use of Account 674 for Corporate Headquarters Expenses

DRA has recommended that AT&T book all corporate expenses to AT&T-C in Account 674, General Services and Licenses, for purposes of consistent reporting on a Uniform System of Accounts (USOA) basis. DRA cited a precedent for this in D.86-01-026 for Pacific Bell (DRA Op. Br., p. 25).

AT&T-C contends, as explained by its Controller Maud E. Thiebaud, that AT&T discontinued the use of Account 674 at divestiture, and that account is not being used for reporting to any regulatory commission. To reinstate Account 674 would be extremely burdensome (AT&T-C Cl. Br., p. 23).

AT&T-C argues that disposition of the Account 674 issue be left in I.87-02-023 relative to revision of the USOA for telephone companies, and not be separately considered in this proceeding. AT&T-C also called attention to DRA witness Simmons' concurrence that a decision regarding Account 674 should be consistent with the final determination in I.87-02-023 (AT&T-C Cl. Br., p. 23 and Tr. 5707).

By D.87-12-063 issued December 22, 1987 the Commission generally adopted the requirement for the use of Account 674 for affiliate company transactions, but exempted AT&T-C from such a specific requirement with the following proviso:

> "g. AT&T shall maintain its data on affiliate company costs on a side record basis and shall not be required to set up a separate and unique subaccount code to record these costs." (D.87-12-063, mimeo. p. 48.)

Since D.87-12-063 has addressed and resolved the Account 674 issue, we will not revisit this matter here, except to use the determination reached in that order for the purpose of future reporting requirements set forth in this order.

VII. National Operations and Management Corporation (NOMC)

AT&T Communications, Inc. operating on a nationwide basis is known as NOMC and manages 22 IECs including AT&T-C's California operations. In addition, NOMC manages AT&T's Interstate Division. NOMC performs support, operational planning, public relations, and management functions on behalf of AT&T Communications, Inc. In addition, NOMC passes through the costs of AT&T-Corporate Headquarters (AT&T-CH) to the 22 AT&T Communications' operating companies, including AT&T-C and its Interstate Division.[7] NOMC thus provides many of the typical general office functions for the 22 IECs that serve as part of AT&T Communications' nationwide operations.

A. Specific DRA Recommended NOMC Expense Adjustments

NOMC has been separately reviewed by DRA auditors because the expenses for its services are allocated differently than those of corporate headquarters AT&T-CH.

1. DRA's Position on NOMC

DRA in its July 31, 1986 Audit Report explained that about 1/6 of AT&T-NOMC expenses were directly assigned and 5/6 were functionally allocated. DRA auditors focused on the functionally allocated NOMC expenses for their further review and proposed adjustments (Ex. 201, p. V-1).

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7 See the "Summary of Decision" section of this order for more details of AT&T's organizational structure.

DRA auditors provided a breakdown of NOMC's estimated functionally allocated expenses for test year 1986 as follows:

Department Source	NOMC's Estimated 1986 Functionally Allocated Expenses Total	Calif. (000's)	Intrastate
Customer Service & Billing	$ 549,420	$ 49,228	$ 13,730
Ext. Affairs-Regulatory	11,503	972	372
Ext. Affairs-Industry Affairs	38,890	3,470	1,436
Ext. Affairs-Public Relations	34,925	2,954	1,127
Finance	620,388	52,067	14,223
Legal	46,422	3,927	1,491
Marketing	1,960,410	179,097	75,768
Network	730,870	56,101	21,875
Personnel	114,045	8,745	3,348
Pensions, Benefits, PR Taxes	77,946	5,825	2,298
AT&T Corp Hdqrts.	291,288	25,116	9,829
Total	$4,476,107	$387,502	$145,497

(Ex. 201, p. V-2.)

DRA's audit team stated that it attempted to narrow the source of NOMC's estimated functional expenses by identifying the activities and projects that would support the recorded dollars for 1984 and 1985. However, according to DRA auditors, the company representatives repeatedly stated that they neither budget nor keep their books and records on such a basis. DRA auditors then explained that as an alternative (to a standard audit of the booked figures) they attempted to gain as thorough an understanding of each NOMC department as possible through meetings with departmental representatives and reviews of examples of departmental outputs. Since most of the functionally allocated costs are generated out of AT&T-C's corporate headquarters in New Jersey, the team states that it conducted part of its investigation there, during the months of May and June 1986. DRA auditors then took the information acquired through these interviews and inquiries, and substantiated the data and statements by sampling departmental outputs. The auditors contend that the use of the more traditional record sampling and detailed audit techniques would have required much more time than was available to them (Ex. 201, pp. V-2 and V-3).

In Chapter V of Exhibit 201, the DRA auditors separately discussed their audits of the External Affairs (regulatory, industry affairs, public relations) Finance, Legal, Personnel and the Operator Services functions' expenses allocated by NOMC. Of the NOMC's estimated expenses allocated to California, in test year 1986, nearly 62% involved customer service and billing, and marketing functions. These expenses and DRA's recommendation, including issues dealing with allocations from NOMC to California, are dealt with in separate sections of this order.

The DRA audit team, while dissatisfied with the lack of project tracking and activity record-keeping, did not make recommendations for significant test year 1986 disallowances for the Finance, Legal, and Personnel functions of NOMC or the Operator Services allocated to NOMC's Network function from AT&T-CH (Ex. 201, pp. V-6 - V-8).

DRA did however recommend that NOMC's estimated test year public relations expenses be reduced for ratemaking purposes by a factor of 97.85% of the budgeted amount. This is the same level of disallowance as recommended by DRA for AT&T-CH's Public Relations Department expenses in the test year.

On the issue of NOMC's External Affairs Department (public relations) activities, DRA Financial Examiner, Tom Doub, contended that the Commission has long regarded activities involving the influencing of public officials or public opinion, or institutional image building as not appropriate for ratepayer funding. He opined, on behalf of the audit team, that this policy is still appropriate because the company is still essentially a regulated utility that enjoys 80%+ of the market, and because proper cost allocation would dictate that these costs belong to investor-related expenses.

Doub then explained that prior to January 1, 1986 public relations was included in the External Affairs budget. The public relations functions were subsequently transferred to AT&T-CH. The budget for these activities (approximately $35 million and 350 people) is expected to remain the same in External Affairs, since the same costs are expected to be billed back from AT&T-CH.

Doub further explained that the amount estimated under the public relations category for 1986 was $34.9 million for AT&T Communications total functionally allocated costs, and $3.0 million for total company California operations of AT&T-C. Since the activities and dollars affecting AT&T-C were expected to be the same during 1986, the audit team felt that it was appropriate to reduce 1986's estimated expenses, for ratemaking purposes, by 97.85% of the budgeted expense, the same proportion that it used for the corporate headquarters public relations expense adjustment. The adjustment amounts to $34.2 million for total AT&T Communications, and $2.9 million for the California operations of AT&T-C (Ex. 201, p. V-4).

DRA made no adjustments for estimated NOMC regulatory or industry affairs expenses in test year 1986, for Phase II of this proceeding.

2. <u>Position of AT&T-C</u>

AT&T-C contends that AT&T's field public relations expense was treated in summary fashion in Chapter V of the audit report. Relying wholly upon the separate conclusions of the auditor reviewing AT&T-CH's activities, DRA witness Doub urged a 98% disallowance of field public relations expense (AT&T-C Op. Br., p. 80).

AT&T-C argues that:

> "in attempting to justify this extreme recommendation, Mr. Doub indicated that he had assumed, based on a corporate reorganization for 1986 consolidating all public relations employees into AT&T Corporate Headquarters, that field public relations activities would be

> the same as those of AT&T Corporate Headquarters (Tr. 5350-51)." (AT&T-C Op. Br., p. 80.)

Kenneth P. Todd, AT&T's Division Manager-Public Relations, testified that locally budgeted field public relations functions were unchanged by this organizational change, which was entirely administrative in nature (Ext. 237, p. 6; Tr. 6687-89, 6696). Further, Todd distinguished the limited, centralized work performed by AT&T-CH (described by the functional activity descriptor documents reviewed by the auditors) as generally separate from the work performed by field public relations personnel (Ex. 237, p. 5; Tr. 6687, 6691-92). Moreover, Todd claimed that AT&T's rate case data request responses and workpapers have consistently shown that the field public relations groups and the AT&T-CH's groups are separate budgeting entities performing separate functions (Ex. 237, pp. 6 and 7).

AT&T-C argues that under these circumstances, it was unreasonable for the auditors to make such a facile and mechanical disallowance recommendation to AT&T's field public relations work - even if it were assumed that the proposed AT&T-CH's disallowance were appropriate.

AT&T stresses Todd's testimony that:

> "[T]he audit Team has chosen to ignore a substantial amount of information the Company provided which describes the various activities of the San Francisco-based AT&T Public Relations group under my supervision, and that of other similar field Public Relations groups. There is little or no recognition of the many important Public Relations activities conducted locally in California to inform Californians about how to use the telecommunications services available to them from AT&T. These field public relations activities represent the bulk of the expenses allocated to AT&T Communications of California which I explained in my original testimony, Exhibit 73 (Ex. 237, p. 5)."

AT&T further argues that:

"The auditors' mechanical application to field public relations activities of a 98% disallowance factor is particularly inappropriate for the one public relations activity analyzed in the Audit Report -- employee communications. The first obvious flaw in this approach is its unfair effect on the calculation of a proposed disallowance. At Chapter IX, in a discussion of AT&T Corporate Headquarters activities, the auditors indicate an intent to disallow 50% of this function. (Ex. 201, p. IX-9). Based on the relative mix of AT&T Corporate Headquarters public relations expense, this equates to a 2% allowance of all AT&T Corporate Headquarters public relations activities; yet, a 50% allowance of field employee communications activities would amount to far more than 2% of all field public relations expense." (AT&T-C Op. Br., p. 82.)

Todd further testified that the purpose of AT&T's employee information activities is not to sell stock to employees, because the ESOP (Employee Stock Ownership Plan) to which DRA auditors alluded, is wholly funded by the company. Todd had also testified that:

"The purpose of AT&T's Employee Information activities is to disseminate timely and accurate information about the company and the telecommunications industry to all AT&T employees. This responsibility is carried out through the publication of bi-weekly regional newspapers, weekly bulletins, a bi-weekly newsletter for Regional employees and videotape programs. Topics covered in the articles and features in these publications include new AT&T Communications service offerings, new technology, significant sales, improvement in the quality of work life and cost-saving measures effected by employees. These publications keep employees up-to-date and well-versed on current issues affecting the public, such as the carrier selection process, the changes in the way customers dial the operator, new service offerings and proposals being considered by state and federal regulators affecting the industry.

"Employee publications are also effective in reporting on the contributions of fellow employees in all departments for the benefit of those who, in carrying out their day-to-day jobs, would likely not be aware of events outside their departments. This enhances employee morale and productivity." (Ex. 237, pp. 7-9 and AT&T Op. Br., p. 83.)

AT&T then renewed Todd's claim that the [DRA] auditors had not identified a single article in a single employee publication that supports their erroneous conclusion of "primarily image enhancement activities." (Ex. 237, p. 9 and AT&T-C Op. Br., p. 84.)

AT&T concluded its argument by claiming that it has fully justified its field public relations expenses. It believes the 98% disallowance factor which DRA would mechanically apply to these useful and beneficial activities is wholly unjustified and in disregard of the record evidence. According to Todd:

"The California public, which is also AT&T's customer body, needs to know as much as possible about available telecommunications services in order to make informed choices and, therefore, get the most value for the prices it pays for the services. Employees can do a better job for the public they serve if they know what is available and how it is provided. Disallowing the expenses for these processes would leave an uniformed public and employee body, if the Company had to curtail its Public Relations activities. Surely this result would not be in the public interest." (Ex. 237, p. 12.)

AT&T contended that it has provided on the record full, factual, and specific descriptions of its field public relations activities and their benefits to California ratepayers. Finally, AT&T-C called attention to this Commission's recognition of its improved showing in Phase I of this case compared to the 1983-84 rate proceeding where it received a 100% disallowance of similar public relations expenses. However, AT&T-C states that we withheld granting it any recovery of public relations expenses until the Phase II record was fully developed on this issue. Now that the record is complete, AT&T-C asks that its public relations expenses be granted in full.

3. Discussion

In Phase I DRA and TURN both opposed any allowance for corporate or field public relations expenses for AT&T-C. TURN contended that much of AT&T-C's public relations effort was corporate overkill and that many of the functions performed by the public relations group duplicated those of the marketing group.

AT&T-C supported its Phase I request for $3.601 million of public relations expenses on total California operations and $1.372 million on an intrastate basis by arguing that these activities provide clear and important benefits to California ratepayers (D.86-11-079, mimeo. p. 91).

AT&T-C also argued that the 100% disallowance adopted by the Commission by D.84-06-111 in 1984 was inapplicable in this proceeding, because the prior disallowance was premised on the lack of explanation or supporting documentation for AT&T-C's request. AT&T-C also opined that if it had presented a full showing for the 1984 decision, public staff would not have recommended any disallowance. AT&T-C in Phase I also cited the decision in the Pacific Bell rate case (D.86-01-026) which allowed 75% of Pacific Bell's requirement for public relations. Based on what AT&T-C termed a sparse showing in that proceeding, the Commission concluded that by its very nature some portion of this expense enhanced the corporate image of Pacific Bell, which is an activity which does not materially benefit ratepayers (D.86-01-026, p. 170). AT&T argued that if, on such a meager record, the Commission allowed most of Pacific Bell's request, surely AT&T-C is entitled to a full award, given the far greater evidentiary detail it has presented (D.86-11-079, mimeo. p. 92).

In D.86-11-079 we stated that "we are inclined to agree that AT&T-C has provided a much improved showing in test year 1986, but our 1984 disallowance was premised on following prior precedents and lack of demonstration of clear benefits to ratepayers." (D.86-11-079, mimeo. p. 93.) We then left the record open to receive DRA's audit report and deferred the issue until the record was fully developed in Phase II.

In Phase II DRA would disallow 97.85% of AT&T-C's California intrastate public relations expenses as allocated from AT&T-CH and NOMC. DRA's recommended disallowance is $1.1 million on an intrastate basis (Ex. 243). DRA used the same 97.85% disallowance factor for AT&T-CH and NOMC.

This Commission has consistently disallowed[8] the majority of all utility public relations activities because these activities generally were viewed as providing greater benefits to shareholders than to ratepayers, and more importantly were not found to be necessary in the provision of a monopoly utility service. However, AT&T-C comes before us with a request to allow such expenses in a test year two years after divestiture and at a time when its customers and potential customers were making IEC selections as part of equal access balloting. AT&T-C raises many supportive arguments for allowing some, if not all, of its public relations expenses.

DRA recommends against significant allowances for public relations activities and functions that primarily benefit corporate image or AT&T's investors.

8 The one exception being D.86-01-026 for Pacific Bell where a 75% allowance of public relations expenses was granted.

Both arguments are sound; however, neither DRA or AT&T-C has prepared or presented a logical or rational middle ground for allowing those public relations expenses that were necessary at, or shortly after, the time of divestiture to respond to the following needs:

- o Timely, accurate, and consistent information to customers and prospective customers of utility services from AT&T-C regarding available services, rates, and optional rates available from AT&T-C.
- o Timely, accurate, and consistent information in response to media inquiries regarding the utility services available from the post-divestiture AT&T Communications companies.
- o Timely, accurate, and consistent information to AT&T-C employees concerning corporate functions, work requirements, redirections, and reorganizations which were necessitated by the divestiture.

These were important one-time public relations requirements which appear necessary both for the benefit of ratepayers and shareholders at and shortly after divestiture as AT&T's overall corporate structure changed to meet its new functional environment.

By providing timely, accurate, and consistent information to the media and the public about its post-divestiture utility services, AT&T-C was able to retain about 82% of the interexchange market. This strength and dominance helps assure reliable service to the most remote rural areas and the ability to meet any growth in demand for new service.

By providing timely, accurate, and consistent information about corporate changes in functions, direction, and reorganization after divestiture, AT&T-C was very likely able to also maintain employee morale at a favorable level to meet its new commitments in the post-divestiture environment.

We should balance ratepayer and investor interests to cover expenses for these three important public relations functions for one rate case cycle.

Since we do not have actual cost data for these functions, we will rely on Todd's tabulation from his Phase I testimony [Exhibit 73, page 5] where the major 1986 Public Relations functions, and the proportion of the total Western Region Public Relations budget they represent were broken out as follows:

		Approx. $*
o Media Relations	31 %	$341,000
o Employee Communications	27.2%	299,200
o Community Relations	5 %	55,000
o Consumer Affairs	24.5%	269,500
o Executive Communications Support	3 %	33,000
o Research and Planning	5.7%	62,700
o Policy Briefings	1 %	11,000
o Administrative/Other	2.6%	28,600

*Calculated amount of allocation to AT&T-C's California intrastate operations for given percentages of budget.

Being mindful to address only those areas where ratepayer interests are evident and sharing those functional costs with AT&T's shareholders, we will allow the following percentages of the functions named and previously described, as follows:

- 25% of Media Relations expenses to account for timely, accurate, and consistent responses to media inquiries only. This assumes that media inquiries constituted approximately 25% of Media Relations effort, for an intrastate allowance of $341,000 x 25% = $85,250.

- 75% of Employee Communications expenses to assure that employees are fully aware of AT&T and AT&T-C's post-divestiture operational functions requirements and goals, and that employees can effectively communicate the nature and availability of AT&T services accurately and consistently with customers on a timely basis. 25% of these Employee Communications expenses are left for the investors to share since effective employee performance is to their benefit as well. This also accounts for any stock performance and other investor information commonly shared by public relations personnel with employees. This results in an intrastate allowance of $299,200 x 75% = $224,400.

- 50% of Consumer Affairs expenses for timely, accurate, and consistent responses to customer and public inquiries as contrasted with AT&T-C's initiated marketing or customer contact functions. This assumes that customer inquiries account for about 50% of Consumer Affairs expenses, for an intrastate allowance of $269,500 x 50% = $134,750.

- 100% of the cost of policy briefings even though there may well be significant investor-related benefits resulting from these policy briefings, resulting in an intrastate allowance of $11,000.

The recap of these reinstated expense allowances is as follows:

o Media Relations	31 % x 25% =	7.75% =	$ 85,250
o Employee Communications	27.2% x 75% =	20.40%	224,400
o Consumer Affairs	24.5% x 50% =	12.25%	134,750
o Policy Briefings	1 % x 100% =	1.00%	11,000
Total		41.40%	$455,400

This 41.4% allowance will be applied to reduce DRA's 97.85% public relations expense disallowance of 1.1 million by $455,400 resulting in a public relations expense disallowance of $644,600 ($.6 million rounded) allocated to AT&T-C's California

intrastate operations. On a total California operations basis, DRA's public relations adjustment of $2.9 million for AT&T-C would be reduced to $1.7 million.

B. Excluding Access Charges for Allocations

In allocating NOMC expenses to AT&T-C, NOMC included access charges as part of its bases for revenues and expenses. DRA auditors removed both revenues and access charges from the bases used for allocating NOMC expenses to AT&T-C's California operations.

1. Position of DRA on NOMC Allocations

DRA auditors claim that NOMC allocated about 31% of its expenses to AT&T-C using a composite three-factor method which averaged revenues, expenses, and investment. DRA auditors contend that access charges should not be part of the revenue or expense components because access charges are merely amounts collected from the ratepayer on behalf of the LEC. DRA auditors claim that AT&T-CH personnel agree with DRA's view regarding access charges (Ex. 201, pp. VII-1 and VII-5). The DRA auditors adjusted the NOMC allocated expenses, by altering the allocations through removal of revenues and access charges (Ex. 10, p. VII-6). This resulted in a reduction of NOMC charges to AT&T-C's total California operations of $5.2 million and $2.1 million on California intrastate expenses (Ex. 243).

2. Position of AT&T-C on NOMC Allocations

AT&T-C at page 86 of its opening brief describes a four-factor Composite B allocation method which was used by AT&T-CH for allocation of its Finance, External Affairs, and Legal Department expenses. This "Composite B" allocation method uses expenses, revenues, assets, and employees to form a weighted average "Composite B" allocation factor.[9]

Next, AT&T observes that:

> "The auditors have recommended disallowance of approximately $2.1 million (intrastate) to these various departmental costs to reflect removal of access expense and an equal amount of revenue from the allocation process. (Ex. 201, p. VII-6; Ex. 206). The alleged bases for this proposal are that AT&T Corporate Headquarters nets access charges against revenues in AT&T consolidated financial statements, that much of AT&T's revenue is intended to recover access costs, and that different commissions may set access expense differently."

AT&T-C then argues that while all of these observations may be true, they do not warrant any adjustment, and AT&T's existing composite allocation methodology should be retained as reasonable and appropriate (AT&T Op. Br., p. 86).

AT&T-C witness Thiebaud explained that access charges are the most significant expense for any AT&T Communications company. For example, in D.86-11-079, access charges were approximately 69% of the total adopted costs of service (Ex. 229, pp. 14-15). Because of this impact, access expense, or a corresponding amount of revenue, may be excluded from total results for the purposes of consolidated financial statements issued by AT&T-CH. This is done merely to allow for comparability of AT&T Communications with other AT&T entities (Tr. 6387).

AT&T-C's Troxel, its witness on allocations, observed that, "what AT&T Corporate Headquarters does for its financial statements is fundamentally irrelevant to the allocation among AT&T

9 We are not aware of any DRA issue with this AT&T-CH four-factor method, because no access charges are included in the revenues or expenses for this method.

Communications companies of nationwide AT&T Communications costs." (Ex. 235, p. 7.)

AT&T-C further argued that finding a flaw with recovering access charges in revenues can be compared with an argument for exclusion of depreciation, or other components in rate base. AT&T-C also contended that it is of no consequence that the various regulatory commissions have established different rates for access charges, or that some commissions have imposed a subscriber line charge to recover non-traffic sensitive access costs, while others have not (AT&T-C Op. Br., p. 87).

After raising a number of additional points regarding similarities and differences in regulatory treatment by various commissions, AT&T-C suggested that:

> "None of the foregoing academic debate prompted by the Audit Report should obscure the fundamental fact that access is the Company's most substantial expense and an essential factor in the determination of prices paid by customers. Proper cost accounting requires the inclusion of access charge effects in the Company's cost allocation methodology." (AT&T Op. Br., p. 88.)

AT&T-C then concluded by referring to further testimony of Troxel:

> ". . . The last point that I would like to make on this issue of access charges relates to 'fairness' as a criterion. It is fundamental in any cost allocation system that an allocation method must be applied uniformly across all cost objectives. The California Audit Team's suggestion to remove access charges from allocation bases would arbitrarily and unfairly shunt AT&T's marketing costs from California to other jurisdictions. The fact is that the California Commission has assigned relatively higher access charges than the average of all state jurisdictions. Pretending that these access charges do not exist is fundamentally unfair and would create partially inconsistent allocations throughout the country. (Ex. 235, p. 8.)

According to AT&T-C:

"The Commission should adopt the expert findings of Mr. Troxel, who determined that AT&T's cost allocation methodologies and processes are appropriate and reasonable, conceptually sound and consistent with generally accepted cost accounting principles (*Id.* at 9). AT&T's actual amounts of revenue and expense, including access expense, should be retained in the calculation of its Composite B allocation factor." (AT&T-C Op. Br., p. 89.)

3. Discussion

After reviewing the arguments regarding the use of access charges in the revenue and expense factors for allocating NOMC's expenses to AT&T-C's California operations, we are persuaded by AT&T-C's own witnesses that such inclusion is flawed.

This is especially apparent when reviewing Thiebaud's testimony that AT&T-CH does not include access charges in revenue for allocating its costs. According to Thiebaud: "AT&T Corporate Headquarters certainly does not consider revenue amounts to be anything other than revenue amounts." (Tr. 6387.)

Thiebaud had also explained earlier that "AT&T Communications' revenues are represented [by AT&T-CH] as net of access for the purpose of comparability with other units." (Tr. 6387.)

Since access charges are collected by AT&T Communications companies in message toll rates and then are passed on to the LECs, these charges do not remain as a part of revenues retained by AT&T. Because of the way access charges are treated, there is no more logic to including them in revenues or expenses, than it would be to include taxes in these factors.

It has long been the policy and practice of this Commission to exclude highly variable expense items such as taxes, depreciation, and uncollectibles in determining the proper expense factor for the traditional four-factor method of allocating the headquarters or general office expenses for a multi-district utility or multistate utility operation.

Access charges are not consistently applied and are highly variable from state to state as verified by AT&T-C's own witnesses. Therefore, these access charges should not be included in either revenues or expenses when revenues and expenses are used as factors for allocating home office expenses. AT&T-CH already nets out these charges accordingly and we believe NOMC would be wise to follow the same practice.

In adopting this position we note that DRA has excluded not only the access charges from expenses, but also revenues. This results in only two remaining factors for allocating the NOMC expenses, namely, expenses net of access charges and investment.

This result seems a little severe. While we generally disfavor the use of revenues as an allocation factor, preferring use of customers or usage as a better proxy of the level of business conducted by a utility district or the statewide operations of a multistate utility, a result which leaves only two factors, when three are used for allocations to other states, does not seem proper.

Since DRA's results are now based on only two factors, it is necessary to apply some factor comparable to revenue as a third factor. Referring to DRA Exhibit 201, page VII-4, we note that, AT&T-C's 1985 usage factor of 8.14% is, "By coincidence...almost the same as AT&T-Communications' 1986 revenue factor recomputed to exclude access charges."

Therefore, we will use AT&T-C's 1985 usage factor as a proxy for the revenue factor exclusive of access charges.

DRA's resulting adjustment for AT&T-C's total California operations is reduced from $5.2 million to $5.0 million and the comparable intrastate adjustment will be reduced from $2.1 million to $1.953 million ($2.0 million rounded) for the elimination of headquarters or general office expenses for a multi-district utility or multistate utility operation.

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Therefore, we will use AT&T-C's 1985 usage factor, which we prefer, as a substitute for the revenue factor exclusive of access charges.

DRA's resulting adjustment for AT&T-C's total California operations is reduced from $5.2 million to $5.0 million and the comparable intrastate adjustment will be reduced from $2.1 million to $1.953 million ($2.0 million rounded) for the elimination of access charges from revenues and expenses for allocating NOMC expenses to AT&T-C.

We also suggest that the usage factor, while in this specific instance comparable to 1986 revenues, is generally a better proxy for consistently determining the level of business activity for each state of a multistate operation than revenues which may well be different from state to state because of differing rate structures and levels.

VIII. Gain on Sale of 195 Broadway

On July 1, 1983, the land and building at 195 Broadway, New York City, the headquarters location of the AT&T General Departments since 1916, was sold for $93.1 million, resulting in a net gain of $47.5 million. Subsequently, AT&T earned nearly $3.8 million interest on an investment of the proceeds. AT&T credited $10.4 million to the licensee companies under the license contract agreement and remitted the remainder to the AT&T Foundation, a charitable trust funded and controlled by AT&T. DRA recommends a reapportionment of this gain with 100% going to the licensee companies. The resulting adjustment to AT&T-C on an intrastate basis amortized over a three-year period would reduce the gross revenue requirement by $882,000 annually, for three years.

1. DRA's Position

DRA Financial Examiner, James B. Simmons recommended that, since the Bell operating companies had made license contract payments, including this building's costs since 1916, its customers were entitled to the gain on sale in full.

Initially Simmons had applied a factor of 55% to the full remaining amount, which had <u>not</u> been allocated to the licensee companies and to California ratepayers through PT&T and Pacific Bell in past years. This 55%, as Simmons explained, in response to the following series of clarification questions, was to reduce this access charges from revenues and expenses for allocating NOMC expenses to AT&T-C.

AT&T-C in its May 31, 1988 comments stated that by substituting the 1985 usage factor instead of its revenue factor would exclude private line usage which contributes 9.2% of AT&T-C's total California revenues.

Accepting the inclusion of the private line revenue percentage with the 1985 usage factor further will reduce DRA's adjustment by about $154,000 for total California and $60,000 on an intrastate basis. The overall effect is a total California adjustment of $4.846 million ($1.893 million intrastate) [$1.9 million rounded]. This result should not be considered as a move on our part to adopt revenues in preference to use as a factor but rather a concern for not omitting a portion of business activity in allocating expenses in this proceeding.

We also suggest that the usage factor, while in this specific instance comparable to 1986 revenues, is generally a better proxy for consistently determining the level of business activity for each state of a multistate operation than revenues which may well be different from state to state because of differing rate structures and levels.

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"Q Now, in your adjustment for the 195 Broadway property, did you take into account these adjustments that the Commission previously made for the license contract --

"A Yes.

"Q -- and give that weight in your ultimate adjustments?

"A Yes, I did. I used the 1980 level of effective disallowance to calculate an allowance factor for the 195 Broadway. And that computes to 55% allowance factor for the 195 Broadway.

"I don't have historical information going back to 1918 to show what the effective equity would be for the effective allowance factor. But I do know that the disallowances were around 50% in the years that I reviewed.

"And, indeed, I think we adopted a 50% disallowance in the interim decision--in the Phase 1 decision in this case, as a representative disallowance factor.

"Q So it is your intention, then, that by use of the 55% factor which you used, that you recognized the fact that the Commission did not necessarily make AT&T [whole] for its 195 Broadway properties over the years?

"A Yes, that is correct." (Tr. 5932-5934.)

Witness Simmons also testified that the 55% factor was not based on a calculation of the actual allowances and disallowances which took place over the years subsequent to 1916, but he felt that "it is a representative and fair allowance factor." (Tr. 5934.)

After AT&T-C had presented its testimony, DRA witness Simmons, in rebuttal, revised his study and recommendation to pass through 100% of the gain allocable to California ratepayers. He explained this revised position by stating that both AT&T-C's 39% factor and staff's 55% factor were understated and he now recommended that 100% of the gain on sale be flowed through for the benefit of ratepayers. He prepared a new table to support his position, which he explained as follows:

> "The schedule clearly shows that the California Public Utilities Commission imposed no disallowances for the years 1916 through 1948. There is a two-year period, 1948-1950, during which the allowed license contract fee was about .84% of estimated revenues. Then, for the period 1950 through 1973, this Commission allowed Pacific a higher amount for license contract expenses than it actually paid to AT&T. This resulted from the fact that allocated actual costs exceeded the agreed-upon rate during that period of 1% of adjusted revenues. Therefore, the Commission's adjustment during this period resulted in an allowance for license contract expense in an amount greater than the amount actually paid by Pacific to AT&T.
>
> "D.83162, issued in 1974, did not identify license contract fees as a specific issue. The next disallowance was made in D.88232 in 1977, wherein a 13.29% downward adjustment was adopted. This previous percentage was composed of 6.04% relating to identifiable investor related expenses, and a 7.25% 'unidentifiable' investor related expenses. The unidentifiable investor interest percentage was challenged by Pacific, and the resulting separate investigation effected a revision to the D.88232 adjustment, in D.90362, to reflect a 38.6% reduction. This was the first thorough study of license contract charges. Finally, in D.93367 (1981), a 57% disallowance was imposed. Excluding the Realignment Adjustment, which was a one-time unusual item relating to detariffed items, this disallowance would have been 45%. This final disallowance would have been in

effect through 1983, when the building was sold.

"The Team has concluded from these facts that all of the gain resulting from the disposition of the 195 Broadway headquarters building should be credited to ratepayers in the current case, given the fact that this building had an estimated depreciation book life of 40 years, and that, at least for 55 years (1918 through 1973), the CPUC allowed nearly 100% of the billed amount of Pacific's license contract expenses. The relatively short period in which this Commission imposed disallowances for license contract expenses (1974 though 1983), would not reduce the ratepayers' equity interest in the 195 Broadway headquarters property, because, by this late date, the building would have been fully depreciated, and therefore, recovered by AT&T from the ratepayers." (Ex. 238, pp. 42-44.)

DRA's recommendation would reduce AT&T-C's California intrastate gross revenue requirement by $882,000 each year for three years when amortized by an expense reduction as suggested by Simmons (Tr. 6921).

In response to a request from the assigned ALJ, Simmons prepared an alternative calculation to reduce, on a one-time basis, the intrastate rate base of AT&T-C by the amount of the similarly allocated gain. The resulting reduction would be $2,647,000 to AT&T-C's intrastate rate base (Tr. 6925 and Simmons' letter of November 4, 1987).

In its closing brief, at page 12, DRA argues that witness Simmons had noted that the estimated depreciation book life of 195 Broadway was 40 years. For at least 55 years AT&T was allowed nearly 100% of license contract costs billed to Pacific. The brief period of disallowances by this Commission occurred after the building was fully depreciated. Thus, AT&T-C's argument that there were cost underruns in license contract fee recovery is not only erroneous, but would overturn historical Commission precedents of what costs were and were not appropriate for ratemaking purposes.

2. <u>AT&T-C's Position</u>

Using essentially the same historical description of the property in question and the same periods of time for discussion AT&T-C sets forth a substantially different analysis of this proposed adjustment. AT&T-C argues at page 123 of its opening brief that from 1918 to October 1, 1974, the Bell System Operating Companies, including PT&T, paid a flat fee to AT&T General Departments for advice and assistance pursuant to license contract. By the very nature of that contractual arrangement, there was no allocation to Bell System Operating Companies of specific AT&T General Departments' expense, such as a return on the pre-license contract investment in the 195 Broadway property. However, effective October 1, 1974, the method of payment under the license contract was revised. Each operating company paid an amount that was equal to its allocated share of specific expenses incurred by AT&T General Departments. These specific expenses included a return on investment in property (such as the 195 Broadway land and building) which was employed in performing license contract work.

Accordingly, AT&T-C explained, when a distribution of the gain from the sale of 195 Broadway was made in 1983, the Bell System Operating Companies received payment in proportion to the period of time (1975-1983) in which they had actually been billed for a return on investment in the property. The ratio of those eight years to the 68 years of the building's life resulted in the $10.4 million distribution to the operating companies. The balance was remitted to the AT&T Foundation.

AT&T-C contends that this distribution has never been challenged by any recipient of the gain, stockholder, or regulatory agency. Nevertheless, the DRA auditors have now questioned this well-settled transaction and are requesting a credit to AT&T

expense, in the test year and beyond, to compensate ratepayers for perceived inequitable treatment.

AT&T-C argues that DRA's recommendation was based on three critical (and incorrect) assumptions:

> "o That a return on 195 Broadway investment was included in License Contract remittances prior to October 1974;
>
> "o That ratepayers of Pacific Telephone and Telegraph fully reimbursed the costs of the 195 Broadway property from 1918 to 1974; and
>
> "o That, if a credit is due to California ratepayers, it should be fully attributed to AT&T's customers and not shared with Pacific Bell's customers."

The staff auditors, as observed by AT&T-C, simply made a statement in the audit report that "ratepayers funded the entire costs, including capital and return on investment...of the General Departments of AT&T."

AT&T-C argues that the evidence does not support this proposition. AT&T-C witness Conrad J. Ankiel, a District Manager in AT&T's Corporate Headquarters' Chief Financial Officer Department, testified that:

> "There was no allocation of specific AT&T expenses to operating companies prior to October, 1974 under the License Contract method of payment in effect at that time. Accordingly, no allocation of specific gains associated with such periods was appropriate."

In addition, Ankiel testified that on a national basis during the 1950s, 1960s, and early 1970s the General Departments of AT&T were not adequately reimbursed for their expenses by the operating companies. AT&T-C claims that even though the figures provided by Ankiel are national representations, and not dispositive of how many dollars California contributed to this underrecovery, all operating companies paid the same 1% of net service revenues that contributed to the underrecovery.

AT&T-C then provided various references illustrating that for test years 1946, 1964, and 1977 there were, despite DRA's testimony, Commission disallowances for AT&T's license contract services to PT&T.

AT&T also remarked that:

> "As stated in 1977 in Decision 88232, these investor-related adjustments became 'traditional' in a combined disallowance factor of 13.29%; these adjustments were in addition to others that were proposed by Staff. (83 CPUC 149, 199). Accordingly, a review of Commission precedent dispels PSD's unsupportable notion that California ratepayers fully funded License Contract activities for the 1946-1974 period."

As to the 1918-1946 period, AT&T-C asserts that DRA failed to introduce competent evidence to support its claim that license contract expense was fully funded.

AT&T-C also argues that if a credit is determined to be appropriate, then it should be to the predivestiture ratepayers of PT&T. If the Commission determines that some adjustment is appropriate, no more than one-half of such an adjustment should be applied against AT&T's revenue requirement, and the balance against Pacific Bell in its next rate proceeding.

In conclusion, AT&T recommends that the Commission reject DRA's adjustment and adopt as reasonable the 1983 disposition of the gain on sale of the 195 Broadway property. Alternatively, if some adjustment is deemed appropriate, any credit due to customers should be split between AT&T-C and Pacific Bell.

3. <u>Discussion</u>

Following issuance of the Audit Report, AT&T-C on May 5, 1987 filed a Motion to Strike. AT&T-C argued that DRA's recommended disallowance to 1986 test year operating expenses violates the ban on retroactive ratemaking. In support of its argument, it cited several cases for the proposition that the Commission is powerless to adopt the auditors' recommendation for an event that occurred in 1983 (see, e.g., Pacific Tel. & Tel. Co. v Public Util. Comm. (1965) 62 Cal 2d 634, and City of Los Angeles v Public Utilities Commission (1972) 7 Cal 3d 331). AT&T-C maintained that the Commission cannot lawfully alter the results of operations finally adopted in D.85-12-091 (in A.83-01-022, the last general rate proceeding) by adopting DRA's recommended ratemaking adjustment.

In its formal response, DRA argued that none of the case law cited by AT&T-C supports the proposition that a prospective accounting adjustment, such as that recommended here, violates the ban on retroactive ratemaking.

Furthermore, assuming arguendo the merits of AT&T-C's position, DRA believed AT&T-C was estopped from making a retroactive ratemaking argument, due to its failure to obtain prior Commission approval of the 195 Broadway transaction pursuant to PU Code Section 851, and its failure to bring this transaction to the Commission's attention during the last rate case when the ratemaking implications could have been considered on a contemporary basis. As events ultimately unfolded, the details of the transfer were first examined during the audit conducted in connection with this test year 1986 proceeding. Considering all these factors, DRA argued that the Commission should disregard the argument of retroactivity (Citizens Utilities Co. of Calif. (1982) 9 CPUC 197, 207).

On June 16, 1987, the then assigned ALJ denied AT&T-C's motion to strike on the basis that the auditors are not proposing a retrospective adjustment to AT&T-C's pretest year 1986 results of operations, but rather a prospective adjustment to rates adopted for test year 1986 premised on Commission review of a 1983 transaction that the Commission did not have the opportunity to review contemporaneously. This is not precisely the question addressed in Pacific Tel. & Tel. Co. v Public Util. Com. (1965) 62 Cal 2d 634, or City of Los Angeles v Public Utilities Commission (1972) 7 Cal 3d 331, which involved questions of the propriety of refunding portions of rates previously fixed by formal, final Commission findings.

As it later developed, AT&T-C's opening and closing briefs did not dwell at length on the issue of retroactive ratemaking. Instead, AT&T-C devoted its more serious discussion to what it believed were inaccuracies in the technical development and calculation of DRA's adjustment.

For example, AT&T-C noted that prior to 1974 charges under the license contract were not separated in a manner which would specify what portion of the payment, if any, was related to the return on investment on the 195 Broadway property. AT&T-C also correctly noted that PT&T's ratepayers did not fully reimburse the costs of the 195 Broadway property, as billed by AT&T-C to PT&T during the period 1918 to 1974.

However, given the average percentage disallowance to PT&T on license contract billings over the years, we conclude the picture was neither as bleak as AT&T-C claimed, nor as rosy as DRA painted. A review of representative decisions from this period does not validate either perspective.

> AT&T-C's example of D.41416 dated April 6, 1948 (relative to A.28211, PT&T's first application after World War II), wherein this Commission adopted an allowance for general services of AT&T which was about 40% less than the amount requested for such services by PT&T, was unusual. This adjustment was much larger than the more usual 13-17% disallowance recommended by the staff in subsequent proceedings.

The reason for this substantial adjustment in 1948 was that the staff had excluded 13.5% of the license contract costs at PT&T's then present rates. At proposed rates the amount allowed by staff and adopted by the Commission did not change. However, since AT&T's billings under the license contract were not based on allocated costs, but rather on a percentage of revenue basis - when the Commission in D.41416 - granted PT&T an increase of $22,455,000, AT&T increased its billing to PT&T proportionately as a percentage of the increased revenue granted by the Commission.

By the same token, DRA's claim that from 1950 to 1973, where allocated expenses exceeded the 1% license contract fee allowances, the Commission authorized the higher costs - was only true at present historical rates before any increase was granted. To check these results, we need only to refer to the Commission's formal file in A.49142 PT&T's test year 1967 rate case.

In that proceeding staff, after various adjustments, allocated $14,520,000 for General Service and Licenses. This was $128,000 more than PT&T had listed as expenses <u>at present rates</u>. However, as staff explained in that proceeding:

> "It should be noted that the basis of the staff's estimate for Ac. 674 is the cost of services rendered by AT&T while company estimates of Ac. 674 are based on 1% of operating revenue (excluding miscellaneous revenue and uncollectibles). The Commission has on many occasions found that the cost basis rather than the percentage

of revenue basis is proper. For example, were Pacific's rate application for $181 million increase in revenue granted, its payments to AT&T under the license contract would increase by approximately $1.8 million with no increase in cost to American." (Ex. 61, p. 11-6.)

When the Commission issued D.74917 on November 6, 1968, it granted PT&T a revenue increase of $50,200,000 (61 CPUC 53, 91); AT&T license contract billing to PT&T would accordingly increase by $502,000 and the so-called excess staff allowance of $128,000 at present rates was washed out and became a modest $374,000 disallowance at adopted rates. This admittedly was a very small disallowance (about 2%) of the amount billed by AT&T (approximately $14,900,000). Thus, DRA's claim of excess allowance did not occur as a final result in D.74917, [or for test year 1970, D.78851, pp. 339, 340].

From the foregoing discussion we conclude that significant license contract disallowances did occur in 1948 (40%) and for 1981 through 1983 (57%). However, for other years the disallowances, when computed, were very likely in the range of 13% to about 17% based on a formula of identified plus unidentified investor interests; for example, D.67369 issued June 11, 1964 disallowed 16.6% of AT&T's billed license fee expenses to PT&T. (calculated from D.67369, pp. 848-851). In addition, during the early years before 1929 there is no record of a disallowance for these services, and there were many other years, such as test year 1967 described above, when the disallowances, if any, were small.

Therefore, on a judgment basis we will reduce DRA's proposed adjustment for the gain on sale of the 195 Broadway building by 25%. This 25% reduction will likely be somewhat greater than the average disallowances of license contract fees for the period from 1918 through to the time of sale in 1983. However, absent a more accurate calculation on a year-by-year basis which was not provided by either DRA or AT&T-C we are compelled to approximate this figure. We believe that the 25% assumed disallowance exceeds the average actual amount over the years and thus will slightly favor AT&T-C.

In response to AT&T-C's third request that any adjustment be shared with Pacific Bell and applied in its next rate proceeding, we note that AT&T passed on only 11.8% of the gain to the predivestiture Bell Operating Companies, and we are advised by DRA that this amount has already been passed through as a reduction in expenses for Pacific Bell's customers (Tr. 6928 and 6929).

Since AT&T-C, at its own election, retained full control over the balance of the gain and neither PT&T nor Pacific Bell ever obtained productive receipt of these funds, we seriously question the wisdom of requiring Pacific Bell to be further involved in this matter.

Lastly, we will not apply the adjustment as an expense reduction amortized over three years as recommended by DRA. We will instead require that AT&T-C place in a memorandum account the amount of $2,000,000 to be credited to its intrastate rate base. This is based on DRA's intrastate adjustment of $2,647,000 (Tr. 6925) reduced by 25% and rounded to the nearest $100,000 as consistently applied herein.

This adjustment to rate base has the advantage of being entirely prospective and would essentially have the same effect as it would have had if accomplished in 1983. One exception is that customers of Pacific Bell who today use an IEC other than AT&T-C will not share any direct benefit from this gain.

The rate base treatment of this gain also recognizes that AT&T-C will continue in business and will utilize newer buildings in California which will add investment to rate base offsetting this one time memorandum adjustment over time. Therefore, this adjustment resembles as closely as possible a requirement that AT&T-C fold back into its operations a gain on sale of an old building that was largely paid for over time by its customers.

Rate base treatment also tempers the annual revenue requirement to be about one-half that which would result by an expense adjustment amortized over a three-year period as suggested by DRA.

DRA should track the revenue impact of this, and other rate base adjustments determined in this decision, so that appropriate records are available for analysis as the Commission considers alternative ratemaking options for AT&T-C.

IX. AT&T-C Affiliated Transactions

A. AT&T Technologies/Western Electric Company, Inc. Adjustment

Historically, Western Electric Company, Inc. (Western) and PT&T were arms of the same corporate entity in the Bell System. American Telephone and Telegraph Company (American) controlled both PT&T and Western through nearly total stock ownership. Western, in addition to acting as the manufacturing branch of the Bell System, also acted as purchasing agent, supply department, developer, storekeeper, installer, repairer and salvager. Western had several wholly owned subsidiaries, including Nassau Smelting and Refining Company, Inc., Teletypewriter Corporation, and Weco Corporation. Bell Labs was owned 50% by Western and 50% by American. Western was by far the largest manufacturer, installer, and procurer of telephone equipment in the United States, accounting for 80% or more of the total domestic business. PT&T, like other Bell System companies, made most of its purchases from or through Western under a standard supply contract. The prices under this contract were fixed by Western.

Because of the close affiliation of Western and PT&T, this Commission regularly adjusted the earnings on sales by Western to PT&T to allow Western no greater return on its investment than was allowed to PT&T on its utility operations.

At divestiture Western became AT&T Technologies Inc. (Technologies), and all ties to PT&T and its successor Pacific Bell were broken as of January 1, 1984. In addition, as part of the reorganization of AT&T after divestiture, Technologies and several other entities dealing with sales, manufacturing, and international activities were combined.

Technologies is now a wholly owned subsidiary of AT&T. Technologies has three principal lines of business: (1) Components and Electronic Systems, which manufactures electronic components for use by AT&T companies and for sale to unaffiliated customers; (2) Federal Systems, which provides equipment and services to U.S. Government agencies; and (3) AT&T Network Systems, which manufactures and sells communications equipment and services to AT&T Communications companies and to unaffiliated communications companies (principally the former Bell Operating Companies). Technologies provides its products and services in competition with other major equipment manufacturers, including Northern Telecom, Stromberg Carlson, Ericsson, and Siemens. The business Technologies conducts with AT&T Communications constitutes only about 10% of Technologies' total sales and the balance of its sales are made in the competitive market.

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

DRA presented its position on Technologies' adjustment through its then Project Manager, Kevin Coughlan, who had formerly testified in three separate rate proceedings relative to predivestiture affiliated transactions of Western/PT&T, recounted the general history of these studies and adjustments from 1929 to the present. He described the Western adjustment as a process of inputing expense and rate base disallowances for PT&T which would prevent the parent AT&T[10] from earning an excessive profit through the sales of products by Western to PT&T. Witness Coughlan testified that in 1965 and again in 1972 the propriety of the Western adjustment was brought to the California Supreme Court for review. The court in the first instance held that the adjustment, "...as the Commission expressly found herein, produces a fair and reasonable result." In the 1972 review the court's opinion was quoted by Coughlan, as follows:

> "Western must be considered part of the utility enterprise, and its prices should be adjusted to reflect no greater rate of return on its sales to Pacific than Pacific is entitled to earn on its operations."

Coughlan also referred to a subsequent Commission order, D.88232 dated December 13, 1977 in A.55492 in which the Commission stated that Western was not guaranteed a minimum return.

Coughlan then described the principles used for segregating the assets of PT&T previously purchased from Western and allocated to Pacific Bell and AT&T-C at the time of divestiture. These assets were divided into two parts with the bulk of the assets going to Pacific Bell, a subsidiary of Pacific Telesis, and the remainder to AT&T-C, a subsidiary of AT&T. This division was made, according to Coughlan, under the "Plan of Reorganization" which was part of the Modified Final Judgment (Ex. 198, 1-5 KPC).

Coughlan explained that the portion of Western adjustment that followed the assets that were allocated to Pacific Bell was then amortized over a 13-year period from 1984. Since Pacific Bell had no further ties to AT&T or to Technologies after divestiture,

10 At the time of divestiture (December 31, 1983) AT&T owned 100% of the common stock of PT&T and Western.

new assets purchased by Pacific Bell from Technologies would no longer be subject to an affiliated transaction adjustment.

For AT&T-C, the affiliated relationship continues to exist. However, purchases of equipment by AT&T-C from Technologies since divestiture have been small, and about 90% of Technologies sales have been made to outside customers. For this reason, Coughlan recommended that the adjustment for assets acquired by AT&T-C at the time of divestiture be amortized over a four-year period with no additions at this time, stating that no material additions to the Western adjustment appear to be merited to date (Ex. 198, 10 KPC). This staff-recommended adjustment would, if adopted, reduce AT&T-C's gross revenue requirement by $2.1 million (Ex. 243).

For the future Coughlan did not recommend elimination of the Western adjustment because the corporate ties between Technologies and AT&T-C continue to exist since both are owned 100% by AT&T. For the years 1984-1986 AT&T-C's construction program was relatively small but this condition could change in the future. Therefore, he recommended that the Commission require AT&T-C to report the following information annually to the DRA and Commission Advisory and Compliance Division (CACD):

a. Annual construction budget.

b. Amount of AT&T-C of California's purchases from Technologies (estimated expense and plant categories.

c. Realized rate of return of Technologies' sales to AT&T-C of California by line of business.

d. Capital structure of Technologies.

2. <u>AT&T-C's Position</u>

AT&T-C argues that since divestiture AT&T affiliates do a majority of their business with non-AT&T customers, at prices that are dictated by competitive market conditions. Also, pursuant to most-favored-customer agreements, AT&T affiliates (including AT&T-C) pay no more for affiliate goods and services than any other customer under comparable conditions. AT&T-C contends that this is a safeguard upon the use of ratepayer money by AT&T-C in making purchases from Technologies, and that DRA's witness Coughlan considered that a condition that would favor ratepayers (Tr. 5279).

AT&T-C's Vice President of Regulatory Matters, Robert B. Stechert, testified that:

> ". . . AT&T Technologies sells its products and services in highly competitive markets. To be competitive, AT&T Technologies must necessarily constrain its return to a reasonable level consistent with its business risk and capital structure as recognized by Mr. Coughlan. The demands of the marketplace thus ensure that AT&T Technologies' prices to all its customers are reasonable. AT&T Communications, which purchases only a small part of the output of AT&T Technologies, automatically benefits from these marketplace constraints. In addition, AT&T Communications is contractually guaranteed a "most favored customer" status, which further ensures optimum pricing benefits in purchases from AT&T Technologies.
>
> "Under these post-divestiture conditions, neither the incentive nor the opportunity exists for AT&T Communications to subject California ratepayers to the burden of "excess" return through the instrumentality of AT&T Technologies. Rather, AT&T Communications' customers are assured that prices for goods and services purchased from AT&T Technologies reflect a reasonable return." (Ex. 221, pp. 10 and 11.)

AT&T-C further contended that its views were supported by the Commission's June 30, 1986 comments filed in FCC Docket 86-111. Stechert believes the Commission indicated in those comments its belief that the appropriate measures for prices paid by utilities to affiliates are the market prices those affiliates establish in providing services in the marketplace generally. Those are the prices that AT&T pays its affiliates for their services (Tr. 5993). AT&T-C argues that the Commission can best demonstrate its faith in market prices in the current proceeding by adopting Stechert's recommendation to discard affiliated transaction regulation for AT&T because of the prevailing marketplace conditions.

AT&T-C also claims that, while not agreeing to a wholesale withdrawal of traditional affiliate return analysis, DRA Project Manager Coughlan also recognized that conditions have substantially changed for Technologies, compared to those faced by Western in the Bell System. Accordingly, AT&T-C contends that, he testified that a different business risk exists for Technologies and that a higher rate of return is therefore appropriate (Ex. 198, p. 10-KPC).

In conclusion AT&T-C believes the evidence demonstrates that the return of Technologies was lower than the 12.35% authorized for AT&T's California regulated operations in the test year, and below the 12.7% applicable to 1984 and 1985 results. Further, if the adjustment is to be phased out, AT&T believes an 11-year amortization period, which coincides with the Commission's treatment of similar plant held by Pacific Bell, should be adopted in lieu of DRA's four-year proposal. AT&T-C also asks that it not be burdened with oppressive reporting requirements, especially for transactions or individual lines of business within Technologies.

3. <u>Discussion</u>

The Western/Technologies adjustment raises three basic concerns: the treatment of predivestiture assets purchased from Western, the 1984 through 1986 AT&T-C purchases from Technologies, and what level of reporting, if any, should be required to keep the Commission informed as to the reasonableness of prices paid by AT&T-C for the products it purchases from Technologies.

First, with regard to the predivestiture assets which were purchased by PT&T from Western and allocated to AT&T-C at the time of divestiture, the assigned ALJ requested that DRA witness

Coughlan prepare a one-page calculation to show the impact on revenue requirement and rate of return of the DRA four-year versus the AT&T-C 11-year and the adopted Pacific Bell 13-year phase-out proposals on a comparable basis (Tr. 5299-5300).

Coughlan's calculation is set forth in the following tabulation:

Western Adjustment

Description	AT&T-C 4-Year Amort.	PacBell[1] 13-Year Amort.	AT&T-C 11-Year Amort.
	(Dollars in Thousands)		
Western Rate Base	($ 3,788)	($ 68,694)	(4,132)
Rate of Return	12.35%	12.52%	12.35%
Net Revenue Requirement	(468)	(8,600)	(510)
Net Revenues	628	3,194	228
Change in Net Revenue Requirement	(1,096)	(11,794)	(738)[2]
Intrastate Rate Base	374,921	10,005,119	374,921
Incremental Rate of Return	0.29%	0.12%	0.20%

Notes:

1 Pacific Bell data from D.86-03-049.

2 $\frac{[\$1.388 \text{ million}]^{3}}{1.8813^{4}}$ = [$.738 million] = [$738,000]

3 AT&T-C Testimony of Maud E. Thiebaud. (Ex. 229, p. 32.)

4 Net to gross Multiplier.

A careful review of Coughlan's calculation and tabulation reveals that because of AT&T-C's relatively small intrastate rate

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Coughlan's calculation is set forth in the following tabulation:

Western Adjustment

Description	DRA 4-Year Amort.	PacBell[1] 13-Year Amort.	AT&T-C 11-Year Amort.
	(Dollars in Thousands)		
Western Rate Base	($ 3,788)	($ 68,694)	(4,132)
Rate of Return	12.35%	12.52%	12.35%
Net Revenue Requirement	(468)	(8,600)	(510)
Net Revenues	628	3,194	228
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3 AT&T-C Testimony of Maud E. Thiebaud. (Ex. 229, p. 32.)

4 Net to gross Multiplier.

A careful review of Coughlan's calculation and tabulation reveals that because of AT&T-C's relatively small intrastate rate base a four-year amortization of the predivestiture Western adjustment would result in a $1.096 million revenue reduction ($2.1 million gross revenue reduction, previously discussed) and a .29% reduction in rate of return.

The 11-year phase-out proposal of AT&T-C would moderate the annual adjustment to $.738 million net and $1.4 million gross revenue (rounded) with a .20% reduction in rate of return to AT&T-C over 11 years. The impact of this adjustment is somewhat larger than that for Pacific Bell using a 13-year phase-out of the assets purchased from Western because of its much larger rate base and earlier, thus longer (13-year) amortization.

We will adopt the 11-year amortization of the Western adjustment suggested by AT&T-C for the remaining (predivestiture) assets purchased by the PT&T and segregated to AT&T-C on January 1, 1984. This treatment will spread the ratepayer benefits over the useful life of the property involved and will also assure that AT&T-C receives the same treatment for this adjusted property as has been accorded to Pacific Bell.

Concerning the 1984 to 1986 assets purchased by AT&T-C from Technologies, DRA and AT&T-C both agree that no adjustment for AT&T-C's purchases from Technologies during this period be made. We will adopt that recommendation.

With regard to the tracking of future purchases by AT&T-C from Technologies, we will adopt the annual reporting requirements requested by DRA, except for the annual determination of "Realized rate of return of Technologies sales to AT&T-C of California by line of business." The balance of the reporting on sales by Technologies to AT&T-C requested by DRA does not appear to be a significant burden to AT&T-C and Technologies. Regarding the realized return on lines of business, we will only require that AT&T-C and Technologies maintain their respective accounting records, including such memorandum accounts as necessary, in a manner which would permit the development of such calculations when AT&T-C's intrastate rates are next determined.

B. American Transtech

American Transtech is a wholly owned subsidiary of AT&T which services securities (stocks and bonds) and provides a variety of shareholder-related services for AT&T and numerous other companies. The work of American Transtech for AT&T, according to DRA auditors, includes administrative support for the AT&T Opportunity Calling Program, including tabulation of call information, handling customer inquiries, and mailing credit status reconciliations; direct telemarketing solicitation for selection of AT&T in equal access areas; preparation of abandoned property reports; data security services, including outside storage of disaster recovery files; record-keeping functions relating to savings plans; and preparation of 1099 tax forms. DRA pointed out that American Transtech also performs marketing, data security, and employee relocation services for AT&T Information Systems, and shareowner services for Corporate Headquarters and the seven regional holding companies which resulted from divestiture. American Transtech also maintains bond records, handles stock transfers, prepares tax information reports, and administers bond calls and maturities for AT&T-CH, according to DRA auditors (Ex. 201, p. X-7).

Except for certain new services, the work of American Transtech for AT&T is essentially the same as that performed by the Stocks and Bonds Division of AT&T's General Department prior to divestiture.

1. DRA's Recommendation

The DRA audit team computed the rate of return employed by American Transtech on work performed for AT&T and found it to be far in excess of that found reasonable for AT&T-C. Therefore, it recommended that these earnings be adjusted to achieve a rate of return equal to that authorized by this Commission for AT&T-C. The

DRA audit team's recommendation would result in an adjustment of $217,000 for total California and $100,000 (rounded) for intrastate operations.

On short notice, DRA auditor James B. Simmons recommended that this adjustment be increased (doubled) because of revisions made in supplemental testimony and development of a new table (Ex. 203). AT&T-C's counsel objected to these last minute changes claiming that the information relied on by the staff for these adjustments was sought and received by staff "...seven or eight months prior to the supplemental testimony date." Then AT&T-C's counsel moved to strike this revision and the motion was granted subject to verification that the DRA auditors had this information for 45 days or more and, therefore, it could have been incorporated in DRA's supplement to the audit report or otherwise provided to AT&T-C at least 10 days before the July 27, 1987 hearings (Tr. 5452). Following this exchange DRA confirmed its previously recommended adjustment of $100,000.

2. <u>AT&T-C's Position</u>

AT&T-C argues that no adjustment to the expenses of American Transtech is appropriate because its services to AT&T amount to about 26% of its business and the remaining 74% is with unaffiliated companies (Ex. 221, pp. 17-18). AT&T-C claims that it pays American Transtech prices that are no higher than those paid by other customers (Tr. 5977).

AT&T-C witness Stechert testified that:

> "American Transtech's prices for its services to AT&T are demonstrably reasonable. Prior to the formation of American Transtech, AT&T's in-house shareowner services expense was $11.08 per account. In 1986, American Transtech's shareowner services price to AT&T was $3.80 per account -- constituting a reduction in AT&T's shareowner services expense per account of about 66%.
>
> "More fundamentally, AT&T Communications' customers are protected by the competitive

> marketplace -- and by American Transtech's beneficial pricing practices -- from any likelihood of unreasonable expenses for shareholder services. The prices charged AT&T are equal to or less than the prices charged any of American Transtech's other customers." (Ex. 221, pp. 18-19).

Moreover, AT&T-C argues that, as a practical matter, the auditors' recommendation was mooted by the receipt into evidence of American Transtech's reduced test year 1986 billings to AT&T for shareowner services. As a result of competitive pressures, American Transtech's prices for these services in 1986 were on average reduced by 32.4% from 1985 levels, and its return on investment decreased by 76.3% (Ex. 248; Tr. 5971-72).

Noting the dramatic effects of DRA's proposed use of 1986 data (a reduction of 93.5%, to approximately $14,000 before separations), AT&T urges the Commission to reject DRA's proposed adjustment and adopt the American Transtech expense incurred in the test year.

DRA counters AT&T-C's argument claiming that AT&T-C's analysis (of the 1986 reductions) ignored the fact that the excess 1985 amount of rate of return was included in the test year estimates and therefore an adjustment was still needed to reflect excessive 1986 prices paid by ratepayers. DRA further contended that the existence of excessive returns in the present competitive environment supports the retention of affiliated transaction regulation, at least for the present.

3. Discussion

The work performed by American Transtech for AT&T does not appear to be subject to significant risk. It is service work that can be planned and carried out on an ongoing basis. It is not subject to even the pressures associated with manufacturing caused by material shortages, on the one hand, or overproduction of similar equipment by other manufacturers, on the other hand. In providing shareholder services, American Transtech can establish realistic and definite work schedules for meeting the needs of its AT&T affiliated customers being reasonably sure that the work will be needed and performed as scheduled.

American Transtech received nearly $25,000,000 in business from AT&T for servicing securities in 1985. AT&T-C has not persuaded us that rendering these services, on an affiliated basis, is any more risky than the utility's interLATA telephone business.

In addition, this Commission and the courts have long held that such services, when provided by an affiliate, should not enjoy a greater return than that authorized for the utility itself (D.67369 dated June 11, 1964, Case 7409). The investor related adjustments made in D.67369 were upheld as reasonable by the California Supreme Court (62 C 2d 634, 662-663).

We will adopt DRA's recommendation of a $100,000 expense adjustment for the investor-related services of American Transtech on AT&T-C's intrastate operations.

C. Bell Labs' R&D

Bell Labs remains the basic research arm of AT&T, as it was before divestiture, and conducts about $2 billion of R&D each year. AT&T's annual budget for R&D and for "Fundamental Research" for the AT&T Communications Sector is $289.2 million in test year 1986 (Ex. 201, p. XI-1). These funds are used by Bell Labs to perform Fundamental Research into solid state physics and other basic sciences, to advance the means by which to communicate or transmit ideas and intelligence. Bell Labs also carries on applied research called R&D into integrated and other existing circuit technology, telephony, and optics to expand, test, and develop new methods and products for communication systems. AT&T-C's contribution to this overall R&D effort approaches $26 million per year for its total California operations (Ex. 201, p. XI-1).

1. **DRA's Position**

DRA witness Maurice F. Crommie analyzed the test year R&D budget for Bell Labs as allocated to AT&T-C's total California operations in the amount of $16.5 million for R&D, and $9.1 million for fundamental research ($6.9 million and $3.6 million, respectively, on its intrastate operations) (Ex. 201, p. XI-1). From his analysis Crommie later determined that Bell Labs realized $3.6 million or a return on investment of 16.2% for these services contrasted with the 12.35% last authorized by this Commission for AT&T-C. He then adjusted the $3.6 million of realized return to $2.7 million to achieve the same return as that authorized for AT&T-C (12.35%) for test year 1986 as follows:

Return on AT&T-C R&D and
Fundamental Research Program
($000's)

	AT&T-C	DRA	AT&T-C Exceeds DRA Amount	Percent
R&D	$2,546	$1,941	$605	31.2%
Fund Rsch.	1,032	787	245	31.1
Total	$3,578[1]	$2,728[2]	$850	31.2%

(Source Ex. 202, p. MFC-1)

Notes:

1 Based on Return on Investment (ROI) of 16.2%.

2 Based on ROI of 12.35% allowed in Commission D.86-11-079.

Under cross-examination Crommie did agree that the Research, Development and Demonstration (RD&D) [sic] program would provide a direct benefit to California customers of AT&T-C. He also agreed that the blanket 50% disallowance previously applied by this Commission to Bell Labs, prior to January 1, 1984..."no longer might be necessary." He agreed that the composite allocation factor used to allocate costs of Bell Labs to AT&T-C and other communications entities was reasonable. He also stated that he had been informed about one other decision (unspecified as to what state or communications company involved) where the rate of return allowed Bell Labs was the same as that allowed to the company.

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

TURN did not address the reasonableness of Bell Labs' charges to AT&T-C in Phase II of this proceeding, but in Phase I it did recommend a full disallowance of the entire amount requested by AT&T-C for R&D and fundamental research (D.86-11-079 mimeo. pp. 110-111). TURN in Phase I argued that the company has the burden of proving that the projects will be used and useful in a reasonable timeframe, that AT&T-C has not done so and, therefore, the entire amount should be disallowed.

3. <u>AT&T-C's Position</u>

AT&T-C argues that Bell Labs operates in an international research environment in competition with numerous industrial, governmental, and academic research entities, and that AT&T Communications Sector funds approximately 40% of Bell Labs' fundamental research and 20% of its R&D work. Bell Labs does research for the Federal Government, Technologies, and other AT&T entities. AT&T-C contends that after a thorough review of the nature, funding, and benefits of Bell Labs' work DRA auditor Crommie found that AT&T's expense for research performed by Bell Labs was reasonable and beneficial to ratepayers, except for the minor adjustment to the rate of return earned by Bell Labs.

AT&T-C argued against the Commission's long-standing 50% expense adjustment for Bell Labs' R&D which reflected the predivestiture 50% ownership of Bell Labs by Western. Since Technologies now contributes its fair share to Bell Labs' R&D

efforts, the 50% adjustment is no longer appropriate. AT&T-C recounted, at page 103 of its opening brief, that: "As Mr. Crommie and AT&T witness Stechert agreed, this 'primary benefit' test is no longer applicable as a result of post-divestiture changes in corporate structure and funding practices."

AT&T-C witness Stechert had testified that business risk should be taken into account:

> "...The Audit Staff's proposal to apply a rigid return-on-investment analysis to AT&T Bell Laboratories expenses is especially inappropriate in this proceeding. Essentially, the Auditors seek to impose for the first time a Western Electric-like adjustment in the research area that would constrain an AT&T Communications affiliate with differing business risk and financial structure at the very time the same Audit Staff recognizes that such an adjustment in the manufacturing area is likely to reflect little or no activity. This fundamental inconsistency in the Audit Staff's recommendations strongly militates against the proposed disallowance for AT&T Bell Laboratories expense.
>
> "My recommendation is to reject the Auditors' proposed disallowance. The competitive market effectively guarantees that AT&T Communications will continue to pay no more than the reasonable costs for research work performed by AT&T Bell Laboratories." (Ex. 221, pp. 15-17.)

AT&T-C also contended that Crommie agreed that Bell Labs faces a substantial business risk that is inherent in all research activities, that the scientist does not know, by definition, how a research activity or experiment will ultimately come out (Tr. 5655).

4. <u>Discussion</u>

While we agree that the simple 50% disallowance which was commonly adopted for the R&D efforts of Bell Labs before divestiture should no longer apply, we are not convinced that, under the present 100% ownership by AT&T (which also owns 100% of

Technologies) there is potentially any difference in the real beneficiaries of the R&D performed by Bell Labs.

It could turn out that Technologies will be the greatest beneficiary of the Bell Labs' research in the future, and Technologies' sales are, at least at the present, predominantly outside of AT&T.

Therefore, the concerns raised by TURN in Phase I of this proceeding that no proof had been advanced that the research being performed by Bell Labs would be used and useful in a reasonable period of time to the ratepayers of AT&T-C are still valid. Witness Stechert brought no new evidence to Phase II of this proceeding to set aside TURN's concerns and arguments. In fact for its argument AT&T-C appears to have relied solely on a statement made by DRA witness Crommie in response to a question from AT&T-C's counsel, that he agreed that there will be a direct benefit to California customers of AT&T-C as a result of the expenditures for research and development (Tr. 5647-5648).

DRA's current audit study and treatment of the allowable funding of Bell Labs are a significant departure from the more traditional disallowance of allocated costs for a sizeable portion of the Bell Labs' effort. DRA's current analysis and recommendations for Bell Labs' expenses are also different from its analyses of energy utilities' research, design, and development expenses. For those expenses DRA performs a program-by-program analysis and then advances recommendations to disallow those programs or activities which are not likely to be, or become, used and useful to ratepayers in the near future. An example of DRA's more specific analysis of energy utilities' research, design, and development activities can be noted by reviewing the discussion at pages 83-90 of D.87-12-066 issued December 22, 1987 in Southern California Edison Company's test year 1988 general rate case.

In response to TURN's Phase I concerns, we hereby place AT&T-C on notice that we will expect, in any future rate proceeding or investigation, a more detailed and affirmative showing by AT&T-C that the R&D efforts of Bell Labs are or will be beneficial to AT&T-C's customers and will be used and useful in a reasonable period of time. We will also expect AT&T-C to address our concerns, that Technologies with about 90% of its sales to outside markets will be the predominant beneficiary of this overall R&D effort.

While we agree with DRA witness Crommie that it is often impossible to predict the outcome of R&D activities, and that poses the risk of uncertainty, such risk is clearly different from business risk.

There is no record that would suggest that Bell Labs will not be compensated for any failing projects. Absent such evidence, it follows that Bell Labs will receive income equal to its established budget, regardless of the outcome of its R&D projects. Thus, Bell Labs' R&D efforts have less business risk, if any, than AT&T-C itself would incur in its intrastate utility telecommunications operations.

Based on this discussion DRA's recommended modest adjustment, to allow Bell Labs to earn the same return on its investment for R&D activities as was authorized for AT&T-C, is the minimum reasonable adjustment we should consider. We will therefore reduce AT&T-C's total California expenses by $900,000 and its intrastate expenses by $300,000 (rounded) as recommended by DRA.

X. Marketing - Use of 1985 v 1984 As a Base For Test Year

Marketing may be defined for the purposes of this proceeding as the aggregate of functions involved in transferring goods and services from producer or supplier [in this case, AT&T

and AT&T-C] to consumer [in this case, a consumer of interexchange long distance telecommunications services].

In D.86-11-079 the Commission adopted $126,623,000 as reasonable commercial expenses for test year 1986, consisting of $22,393,000 for advertising and $104,230,000 for marketing activities on a total California basis. In AT&T-C's application for rehearing of D.86-11-079, it requested that the Commission substitute 1985 in lieu of 1984 as the baseline year for calculating the appropriate marketing expenses for test year 1986.

The Commission, by D.87-04-041 dated April 8, 1987, did grant limited rehearing on this remaining marketing issue based on the following discussion in that order:

> "...for reasons of equity, we have decided to allow AT&T-C to present argument, based on the existing record, on the question of whether 1985 is a more appropriate year than 1984 to begin our determination of allowable marketing expenses for test year 1986. We caution AT&T-C that the limited rehearing we grant on this issue is solely for the purpose of allowing the parties to address the above question, and to receive into evidence figures describing specific 1985 expenditures. During this rehearing, we will not allow any additional testimony concerning justification of those or any other expenses, nor will we allow additional testimony on any other marketing/advertising-related issue. Our focus now should be the OII. To ensure that Phase II of this proceeding is not prolonged any more than is absolutely necessary to give AT&T-C its day in court on this issue, we will limit AT&T-C's showing to one hearing day, and the PSD's and TURN's showings to one-half day each.
>
> "We note that by granting this limited rehearing, we are not implying any preconceived commitment to moving to a 1985 base. In making the ultimate decision, we will weigh AT&T-C's new 1985 evidence against the existing state of the record on the cost-justification question, reflected in Findings 24 and 26 of D.86-11-079, as modified below. Such a balancing of equities is crucial to reaching a decision

> which is fair to both AT&T-C and its California ratepayers." (D.87-04-041, mimeo. pp. 2 and 3.)

1. DRA's Position

DRA did not recommend that 1985 be used as a base year for marketing, claiming there was no evidence presented by AT&T-C to show that 1985 provided a better year than 1984 for purposes of estimating 1986 marketing expenses. DRA argued that its analysis of 1985 pointed to the opposite conclusion and major adjustments would be necessary to 1985 expenses should this be used as the representative or normal year.

DRA's Financial Examiner Francis Fok testified that three significant adjustments would need to be made to AT&T-C's booked number for 1985, prior to using it for ratemaking purposes. He then itemized these adjustments as follows:

> "a. Equal Access;
> b. Billing and Collection; and
> c. Force Reduction Expenses." (Ex. 246, p. 3.)

Fok explained the need for these adjustment as follows:

> "Equal Access stemmed from the Modified Final Judgement of the AT&T divestiture proceeding. All telephone customers were to select a long distance telephone company as their primary provider. Access to such selected provider's service was to be automatic (i.e. not having to dial a long access code). Cutovers primarily took place in 1985 and 1986. After being cutover, customers who wish to switch to another long distance company will have to pay a service fee to their local exchange telephone company." (Ex. 246, p. 3.)

Fok determined that AT&T-C expended significant sums of money to promote subscription of customers in order to maintain and/or expand its market share, and the audit team recommended that such expenditures for equal access be excluded for ratemaking purposes because: Expenses to maintain or increase the company's market share in the face of competition had not been considered appropriate by this Commission, and this promotional program was a non-recurring, unusual, and significant event over and above a regular marketing effort in a normal year. Fok opined that the unusual nature of these (equal access) expenses made them unsuitable for inclusion in ongoing rates developed for a test year (Ex. 246, p. 4).

Fok also explained the rationale for his billing and collection adjustment as being consistent with the deferral and capitalization of billing and collection developmental costs by DRA witness Simmons (Ex. 246, p. 4).

Regarding his force reduction expense adjustment, Fok explained that those are expenses associated with early retirement incentives, severance payments, and employee relocation expenses incurred in AT&T-C's attempts to reduce its operating costs. He believed that the benefit of such a large scale reduction extends beyond the year in which these force reduction costs were incurred (Ex. 246, p. 5).

Using the 1985 recorded base amount with these adjustments, including a three-year amortization of employee force reduction expenses, DRA arrived at a 1986 marketing expense allowance of $86.89 million which was lower than the booked 1984 marketing expense amount of $96.460 million and $17.34 million lower than the $104.230 million already adopted for test year 1986 by the Commission in Phase I (Ex. 246, Appendix B and D.86-11-079, p. 90).

DRA argues that the booked 1985 marketing expenses without these adjustments, for equal access, capitalized billing and collection and three-year amortization of employee force reduction expenses, would reflect marketing expenses at their highest in this three-year period. A peak year is not suitable as a representative year.

As a further argument against a higher marketing base, DRA challenged AT&T-C's claim for the need of added marketing appropriate by this Commission, and this promotional program was a non-recurring, unusual, and significant event over and above a regular marketing effort in a normal year. Fok opined that the unusual nature of these (equal access) expenses made them unsuitable for inclusion in ongoing rates developed for a test year (Ex. 246, p. 4).

Fok also explained the rationale for his billing and collection adjustment as being consistent with the deferral and capitalization of billing and collection developmental costs by DRA witness Simmons (Ex. 246, p. 4).

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DRA argues that the booked 1985 marketing expenses without these adjustments, for equal access, capitalized billing and collection and three-year amortization of employee force reduction expenses, would reflect marketing expenses at their highest in this three-year period. A peak year is not suitable as a representative year (DRA Op. Br., p. 32).

As a further argument against a higher marketing base, DRA challenged AT&T-C's claim for the need of added marketing activities to cover the continuing customer change of carrier selection. DRA stated that:

> "On December 7, 1987, AT&T-C distributed a response to an ALJ request for further information on the alleged 20% 'churn' rate to which AT&T-C witness, Mr. Fuller, testified. The 'churn' rate is the continuing customer change of carrier after the initial selection process is over. AT&T-C's response provided support for a rate of 8.8%. Testimony that the rate is 20% was not substantiated. It may be that some degree of 'churn' will always be present after the equal access cutover. However, staff would expect all carriers to address retaining customers, as well as wooing new customers, in normal marketing strategies without additional costs. Whatever the churn rate may be in 1986 and future years, the scope and size of customer selection in 1985 and early 1986 would not reoccur." (Op. Br., p. 31.)

DRA thereby concluded that 1984, rather than 1985, was a more representative base year for determination of reasonable marketing expenses for AT&T-C in test year 1986.

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

TURN appeared in Phase II, and brought back Joseph H. Therrien, Vice President of Marketing Communications of Winston Management, Inc., as its witness on the marketing issue. Therrien had testified on the marketing issue for TURN in Phase I of this proceeding and contributed effectively to the record on the marketing issue at that time. On the question of substitution of 1985 for 1984 as a base for estimating, Therrien testified as follows:

> "As far as I can see, AT&T is trying to substitute one set of hollow, unjustified figures for another. All we can say for certain about the 1985 number is that it's higher than the 1984 number. It suffers from all the same infirmities I discussed in my initial testimony:
>
> "First, there has still been no effort to disaggregate this figure to show that any or

all of the programs or activities it covers are beneficial or cost-effective. While I recognize that the Commission has restricted the introduction of background information that might justify 1985 expenditures, it seems clear from the cross-examination and ALJ examination of AT&T witness Thiebaud that the utility still does not prepare these basic analyses. For example, AT&T cannot distinguish costs of servicing existing customers from those of marketing for new ones (See generally Tr. Vol. 54, at 6642-6678). AT&T-C still hasn't justified one cent of the $60.5 million they claim to have spent in 1985.

"More broadly, AT&T-C has never justified their astronomical marketing and advertising expenditures -- for 1984, 1985 or any year -- which all seem directed toward maintaining the utility's 80+ percent market share. Normally, the client for advertising and marketing services would demand extensive justification for such expenditures. Yet California ratepayers are being asked to sustain expenditures for marketing and advertising that have never been justified to anyone, and seem far too high. In my opinion these costs are better borne by AT&T's shareholders.

"Finally, the utility itself has denied that 1985 was a business-as-usual year, that otherwise might have been claimed as a more secure baseline than the tumultuous first year after divestiture. Instead, AT&T points out that marketing approaches and organizations are still undergoing major changes -- the take-back of billing and collection is a major example that is continuing in 1987 and beyond..." (Ex. 247, pp. 3 and 4.)

Therrien continued by stating that:

"Just because AT&T spent the money doesn't make it reasonable. In fact, huge increases for poorly-defined projects all but guarantee that the money would have been poorly spent." (Ex. 247, p. 4.)

Then he concluded his testimony with the following recommendation to the Commission:

> "AT&T has provided nothing to indicate that 1985 represented a post-divestiture business-as-usual baseline, nor that any part of the spending in that year was cost-justified by the utility's management. Under these circumstances, the Commission has no basis for substituting a 1985 base for the 1984 base developed in D.86-11-079." (Ex. 247, pp. 4 and 5.)

TURN in its brief emphasized that no showing had been made by AT&T-C, that the expenditures were necessary to maintain or expand the utility's 80% market share. TURN argues that AT&T-C has met no reasonable standard of proof regarding its marketing budget.

TURN's counsel concluded by arguing that, while the over-generous budget adopted in (D.86-11-079) has become final, the Commission can still affirm its responsibility by refusing to substitute AT&T-C's unsupported 1985 data as a basis for 1986 expenditures. TURN recommends that the Commission issue a finding that this new data is unusable, and direct AT&T-C to produce better justifications in its next proceeding (Brief at p. 3).

3. AT&T-C's Position

AT&T-C, in its opening brief at pages 52-54, stated that in its Phase I order, the Commission made an interim award of $104.2 million on a total California basis, resulting in a $44.7 million marketing expense allowance on an intrastate basis. AT&T-C calls attention to the fact that the Commission used an unadjusted 1984 baseline plus a consumer price index (CPI) inflation factor in arriving at its test year marketing expense allowance (D.86-11-079, pp. 90-91).

AT&T-C argues that, in its application for rehearing of the interim decision, AT&T requested the Commission to substitute 1985 as the baseline year for its calculation of a final award for marketing expense. AT&T believes that it showed that the Phase I record evidence--particularly the undisputed testimony of Mr. Zemke of the Marketing Regional Vice President Staff--demonstrated that, of the two years, 1985 was far more representative of 1986 conditions. The company's first year of operations was 1984. AT&T-C also alleges that at the beginning of 1984, PT&T had not assigned a stand-alone sales force or adequate information systems to AT&T at divestiture, AT&T had not developed its own customer service capabilities, and the first carrier selection activities associated with the deployment of equal access were still months away. As 1984 passed, AT&T claims that it gradually built up its sales force and support systems, deployed its first account inquiry and service order entry work centers, and began to contend with the difficult competitive challenges inherent in carrier selection. AT&T-C argues that all of these activities were reasonable and necessary to meet customer needs. The critical fact, it says, is that these activities were implemented gradually, and often late, in the year; because these expenses were for only a partial year, the use of actual 1984 expense as a baseline severely understates a full year's worth of expense for these functions.

By contrast, AT&T-C argues that the 1985 expense was comprised of the true annual expense of activities started in 1984, together with increases in force and facilities due to the further deployment of customer service work centers and management information systems, and due to the FCC's mid-year alteration of the allocation procedures for so-called "default" customers. These customer support functions and market conditions continued through 1985 and 1986. Accordingly, 1985 should be substituted for 1984 in the Commission's methodology.

In its application for rehearing, AT&T estimated that the 1985-plus-inflation award would be $139.8 million, on a total California basis, or $61.0 million intrastate. Because no party had addressed 1985 actual marketing expense exclusive of advertising, there was no Phase I record support for AT&T's

estimate. In D.87-04-041, the Commission granted a narrowly focused rehearing limited, AT&T-C contends, to receiving into evidence AT&T's 1985 booked marketing expense. In Phase II, AT&T believes it has shown, with DRA's concurrence, that its intrastate marketing expense was $60.512 million in 1985 and that $62.69 million is the award that would result from use of an unadjusted 1985-plus-inflation methodology.

While other AT&T witnesses briefly discussed marketing issues, Mike D. Fuller, Revenue Support Manager of AT&T's Western Region Marketing Office, and Controller Maud E. Thiebaud testified in support of its position that 1985 was a more representative baseline than 1984 for a test year 1986 marketing allowance. Fuller disagreed with DRA witness Fok that carrier selection was a "non-recurring, unusual, and significant event over and above the regular marketing program." Fuller instead opined that carrier selection did not end in 1985 but "continues each time service is ordered, expanded, changed, or moved" (Ex. 245, pp. 2 and 3). Fuller concluded.

> "To be competitive in the California marketplace, carriers must maintain ongoing programs which provide useful information to customers and facilitate the selection of their long distance carrier. Because customers have the freedom and the power to change their carrier of choice whenever they wish, routine and vigorous marketing to these customers is now a permanent condition in the competitive interexchange market." (Ex. 245, p. 5.)

On cross-examination, Fuller explained that, in addition to all the activity associated with the normal additions and deletions of lines, AT&T-C would also experience a large customer reselection of IECs after equal access. He called this reselection "churn" and estimated it to be 20% over an unspecified period of time. DRA's counsel and the assigned ALJ questioned the 20% figure and asked Fuller to verify it and over what period it occurred (Tr. 7037-7044).

After further review by Fuller, AT&T-C responded by letter on December 7, 1987, to the ALJ, that the "churn" rate was greater than 8.8% for the period of October 1984 through September 1987. For the first nine months of 1987 the verifiable churn rate was approximately 3.2%, and in a separate workpaper, provided by Pacific Bell to AT&T-C, an estimate of 4.8% churn was made for the full year 1987.

Fuller was also questioned about AT&T's marketing practices before and after initial carrier selection. Fuller responded as follows:

> ". . . If your question is did we send reballot mail pieces and telemarketing to people that already selected us, no. That's an irritation to the customer, so we did not do that.
>
> "If the question is do we have other activities that continue to focus us as the favorable vendor, as perhaps a mail piece that informs them of other services that have been offered or a rate reduction that now allows them better use of their monthly phone bills, we continue to do those kinds of things, and to us that's also carrier selection-related behavior." (Tr. 7050-7051.)

Fuller was also asked how many direct mail pieces were sent to California in 1986. He responded in Ex. 252 as follows:

> "Approximately 5.8 million carrier selection letters were mailed to Californians in 1986, including 1.6 million acknowledgement and confirmation notices following selection. The average cost per item including postage was 40 cents for the residential mailings and 69 cents for business mailings."

Thiebaud and Fuller were questioned on what advantages the large number of AT&T-C's smaller customers could expect to gain by a 5% to 10% saving (25¢ to $1) on AT&T-C's monthly bills of $5 to $10 or less, when LEC conversion charges and other costs would offset the savings of switching for a year or more. Fuller responded that to attract AT&T-C's customers, other IECs were willing to reimburse potential customers for the LEC's carrier conversion charge of $5.26.[11]

Thiebaud had earlier presented testimony confirming AT&T-C's recorded 1985 marketing expense of $138.9 million on a total California basis and $60.5 million on an intrastate basis (Ex. 229, p. 36 and Ex. 244, p. 5).

Thiebaud then recommended that the Commission totally reject DRA witness Fok's recommendations for reductions of the 1985 baseline amount. She opined that DRA had not challenged the accuracy of the recorded amounts and she recommended their adoption as the 1985 baseline. Accordingly, using the addition of an

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11 He provided two written examples of such offers as part of Ex. 252, and explained that:

> "In addition to the attached examples, the following interexchange carriers were surveyed by telephone on October 12, 1987:
>
> Allnet
> Execulines, Inc.
> MCI
> Starnet
> US Sprint
> Western Union
>
> "Each of these interexchange carriers offered to reimburse the $5.26 conversion charge, and one, Allnet, offered an additional $5.26 reimbursement to convert back to the original carrier if a customer was dissatisfied with Allnet's service.
>
> "Considering the direct mail examples, the telephone survey results, and the fact that Pacific Bell and General Telephone provide at least one free carrier change in the first 180 days following central office conversion, the $5.26 conversion charge is not an effective impediment to customers interested in trying new interexchange carriers." (Ex. 252, p. 2.)

inflation factor, as the Commission had done in D.86-11-079, she recommended adoption of $143.9 million on a total California basis and $62.7 million on an intrastate basis as AT&T-C's allowance for 1986 marketing expenses (Ex. 244, p. 5).

Under cross-examination Thiebaud did agree that once carrier selection had been made, there were likely a significant number of customers who were neither moving nor dissatisfied with their carrier and "we probably don't have to worry about them." However, she deferred to Fuller questions on how AT&T-C dealt with customers who, for whatever reasons, would have to reselect a carrier (Tr. 7000-7001).

Thiebaud did confirm that "by about September 1986, a large majority of equal access had been completed. We still are in the process of going through the equal access conversion." (Tr. 7005.) In addition, AT&T-C did not present any evidence that it was losing significant numbers of customers to other IECs, irrespective of the other IECs' offers to cover the reselection charges imposed by the LECs.

Notwithstanding the concessions of Fuller and Thiebaud, AT&T-C argued: that Fok's adjustments to the 1985 baseline figure were inappropriate; that Fok's billing and collection adjustment would be mooted by the decision on 1986 audit adjustment; that carrier selection activities were similar for both 1985 and 1986; and that customers were perennially free to reselect primary IECs and, any many did so. AT&T-C also argued that 1985 and 1986 were very similar years reflecting very similar marketing requirements (AT&T-C Op. Br., pp. 55 and 56).

Finally, AT&T-C argued against Fok's proposed adjustments for force reduction expenses on the grounds that such reductions in force "in 1985 were routine and ordinary, rather than being of the 'large scale' perceived by Mr. Fok." AT&T-C also pointed to Thiebaud's testimony that the average number of employees in the marketing department was approximately equal in 1985 and 1986 and that salary expense for all groups, whose costs were assigned to marketing, increased from 1985 to 1986.

AT&T-C then urged that the Commission reject all proposed adjustments to 1985 marketing expense in its determination of the test year marketing award (Op. Br., p. 67).

In its closing brief AT&T-C renewed its arguments against DRA's proposed adjustments, and also challenged TURN's witness Therrien. AT&T-C argued that Therrien's career experience was in advertising, not marketing, and advertising was not an issue in Phase II. AT&T-C also contended that during the two years of litigating this proceeding Therrien never reviewed any of its marketing department's extensive confidential business records or data, never requested to visit any AT&T work center, and never interviewed a single marketing representative of AT&T.

Simply put, AT&T-C argues, Therrien was uninformed on the specifics of AT&T's marketing operations and failed to recognize the deployment and growth in customer service and support functions that required budget increases over the 1984 level (Cl. Br., pp. 20-21).

4. <u>Discussion</u>

In AT&T-C's 1984 test year proceeding, the Commission considered AT&T-C's budget request for combined marketing and advertising of $182,050,000 representing approximately $13.50 for each of the then roughly estimated 13.5 million access lines. It also considered its staff's recommended combined marketing and advertising allowance of $53,000,000 representing about $3.93 per access line. In D.84-06-111 the Commission determined that:

> "...the staff's proposed allowance of $53,000,000 for advertising and marketing, while only 29% of AT&T-C's $182,050,000, would still provide for expenditure in 1984 the not inconsiderable sum of $3.93 for each of the state's 13.5 million access lines. Recognizing the unusual circumstances faced by AT&T-C in establishing itself in the newly competitive field of interLATA communications the

> Commission finds, by exercising its expertise and judgment, that $5 per access line, or $67,500,000, for total California AT&T-C marketing and advertising, is a reasonable allowance for advertising and marketing expense combined." (D.84-06-111, mimeo. p. 96.)

In Phase I of this application the Commission had before it AT&T-C's combined marketing and advertising budget request of $200,856,000 for test year 1986. In Phase I, DRA recommended combined allowance of $89,623,000 for marketing and advertising based on disallowance of corporate advertising and a reduction of 50% of all other advertising. On the marketing side DRA established a range using the divested amount of marketing expense of $38 million for 1984 as the lower end and the actual $96.5 million marketing expense for 1984 as the upper end and then dividing the sum by two. By this calculation DRA would allow $67.230 million for marketing expenses.

In Phase I, TURN presented evidence critical of DRA being too favorable to the company, claiming that DRA began with the assumption of some validity of the company's requested 1986 figures, in the absence of any justification by the company. TURN believed that the company did not justify $22 million of advertising or for the $96 million of marketing expenses. TURN stated its preferred approach was to begin with the divested amounts for advertising of $11,010,000 and $38,000,000 for marketing, and escalate those figures by the media inflation level for advertising and the CPI for marketing. The resulting TURN recommendation for test year 1986 advertising expense allowance was $12,973,000 and for marketing was $41,060,000 for a total of $54,033,000. TURN also offered two alternatives using the 1984 staff's recommended level of $53 million adjusted for inflation to arrive at the first alternate of $58,734,000 and the Commission adopted 1984 level of $67,500,000 inflated to $79,533,000 using the media inflation factor and inflated to $72,937,000 using the CPI inflation factor, as additional alternatives.

In adopting a level for 1986 in D.86-11-079 at page 87 (mimeo.), the Commission stated that:

> "AT&T-C's request of $200.9 million represents more than a 200% increase over the $67.5 million awarded in our 1984 decision on a combined basis. This is obviously far more than the rate of inflation experienced during the intervening years. However, AT&T-C has never accepted the 1984 disallowances in this expense category (totaling $114.5 million) and has been spending in excess of the amounts authorized, thus opting to require its shareholders to absorb these excess amounts."

The Commission also expressed concern relative to the ratepayer benefit of this marketing and advertising activity stating:

> "AT&T-C has expended considerable effort in this case to explain the organizational structure of its marketing budget process, and the competitive environment of the 1986 marketplace in which it operates. It has provided substantially more information in this proceeding than it provided in 1984. However, sheer numbers of witnesses and copious amounts of information, while helpful and preferable to a paucity of information, do not automatically mean that an applicant has met its burden of proving that the amounts it requests are reasonable. This is especially true where disturbing questions exist about the magnitude of the level it requests in these expense categories. This question really goes to whether and how the levels of advertising and marketing AT&T-C proposes to pass on to California ratepayers actually benefit the latter..."

* * *

> "One of the very real dilemmas we face is attempting to gauge how much California ratepayers should be required to pay to be persuaded to remain with AT&T-C in this equal

access environment. We believe that we have a responsibility to ensure that California ratepayers do not shoulder an inappropriate level of costs in order to allow AT&T-C to wage its all-out battle with the competition. We see no benefits to ratepayers in allowing this to happen by giving AT&T-C virtual carte blanche in this area. We must set some limits, given our established ratemaking policies on the commercial expense area, and their focus on a demonstration of ratepayer benefits. Therefore, we must reject AT&T-C's $200.9 million request, because we believe it is unreasonable to require California ratepayers to bear the costs of this excessive amount." (D.86-11-079, mimeo. pp. 87, 89.)

Following the above discussion the Commission made the following determination:

"For purposes of establishing a reasonable commercial expense, we will use the amount of $126,623,000. This amount consists of allowances of $22,393,000 for advertising and $104,230,000 for marketing, derived as follows:

"a. We use PSD's recommendation of $22.393 million for advertising, given the fact that it is based on PSD's review of AT&T-C's 1986 request, coupled with the application by PSD of this Commission's recognized ratemaking policies, to disallow institutional advertising. PSD's adjustment of 50% is appropriate given the fact that much of AT&T-C's advertising request does have the effect of institutional advertising. (See TURN Opening Brief, pp.36-38.)

"b. For the marketing component, we use as a starting point the $96.460 million actually spent by AT&T in 1984. We recognize that this amount is in excess of the amount authorized in 1984 (remembering that the $67.5 million is a combined figure for marketing and advertising), but we believe it provides a good starting point because presumably it represents a de facto sharing of

> these dollars between the ratepayers and shareholders.
>
> "c. We adjust this $96.460 million starting point to account for the rate of inflation in intervening years; in accordance with TURN's recommendation in this case the adjustment is 4.3% CPI inflation for 1984 and 3.6% for 1985 (see Exhibit 122 footnote 1).
>
> "d. Applying these adjustments, we arrive at a marketing expense allowance of $104,230,000 on a total California basis." (D.86-11-079, mimeo. p. 90.)

The advertising allowance is not an issue in Phase II. However, to place the overall amount on a comparable basis with the 1984 award for combined marketing and advertising of $5.00 per access line, the $126,623,000 represents over $8.90 per access line, assuming a 5% increase in the 13.5 million access lines from 1984 to 1986, for an assumed 14.2 million[12] access lines for 1986.

In D.87-04-041, we granted limited rehearing on the narrow issue of "...whether 1985 is a more appropriate year than 1984 to begin our determination of allowable marketing expenses for test year 1986." (supra.)

On this point DRA and TURN presented additional evidence to buttress the 1984 base (of $96,460,000) as the appropriate base year; on the basis of their studies, with increases for inflation, these parties maintain that the Commission in D.86-11-079 has

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12 This 14.2 million assumed number of access lines for 1986 is based on the 13.5 million access line number used in D.84-06-111 increased by 5% and rounded up. This figure appears reasonable when compared with the total number of recorded end-of-year customers of all California local exchange telephone companies, as reported in their 1986 annual reports to this Commission. That total is 13,548,753.

already adopted a more than adequate marketing allowance of $104,230,000 for 1986.

DRA would not use the composite recorded 1985 amount of $138.9 million and merely allocate it to California; however, if the 1985 amount is used, DRA would make adjustments as described earlier, and arrive at a 1986 allocated and adjusted amount of $86.89 million as its recommended allowance for the test year. Of course, this result is a marketing allowance for the test year that is $17.34 million less than that already adopted in Phase I. (supra.)

AT&T-C's position remained that the 1985 recorded and unadjusted amount allocated to California of $138.9 million should be increased for inflation to $143.9 million and adopted as its marketing allowance for the test year. However, as DRA asserted in its brief, the use of 1985 marketing expenses without adjustment would reflect marketing expenses at their highest in this three-year period [1984-1987] (Op. Br. 32 and Ex. 246, pp. 6-7).

In considering these widely divergent views of the parties in Phase II of this proceeding, especially concerning AT&T's expanded marketing efforts in preparation for equal access in 1985, and its subsequent reorganizations, it would be difficult to conclude that 1985 (as booked) was a representative base year for establishing reasonable marketing levels for future years. The adopted test year marketing expense should instead be representative of a reasonable amount for a normalized three-year period until the next general rate case cycle, and not a peak year expenditure at the time of carrier selection. Also, despite AT&T-C's position, AT&T-C's witnesses Thiebaud and Frank agreed that once carrier selection has been made, AT&T does not direct further marketing efforts towards these otherwise satisfied customers, in order to avoid irritating them. (See earlier discussion under "AT&T-C's Position").

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As is evident from this background and from our Phase I decision, we have been uncomfortable all along with the record that has been developed on marketing expenses. Our decision that authorized the use of inflation-adjusted 1984 actual data was a compromise based on the lack of a complete and appropriate rationale from either TURN or from AT & T-C, the two parties whose showings we found most probative.

We would have preferred to utilize TURN's methodology exclusively, for its witness Therrien proved the most credible on this issue. Nevertheless, we were forced to find a more reasonable starting point for marketing expenses than was presented by TURN.

13 While AT&T-C's overall recorded 1986 marketing expenses were higher than in 1985, AT&T-C's marketing force counts began a decisively downward trend after reaching a plateau in mid-1986 (Ex. 246, p. 7 and Appendix C).

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13 While AT&T-C's overall recorded 1986 marketing expenses were higher than in 1985, AT&T-C's marketing force counts began a decisively downward trend after reaching a plateau in mid-1986 (Ex. 246, p. 7 and Appendix C).

Furthermore, in Exhibit 250, AT&T-C established that 32% of its business and 62.7%[13] of its residential customers are small users of interLATA and interstate toll [AT&T-C services]. Due to the relatively insignificant cost savings impact[14] that alternative suppliers of interLATA or interstate service could provide to these small use customers, there would be little cause for AT&T-C to spend significant time or marketing resources on these customers, unless for some reason they become dissatisfied with AT&T-C service (Tr. 7000). Furthermore, there is no evidence of poor service by AT&T in the Phase II record, if anything, there are numerous comments or opinions of good service provided by AT&T.

Therefore, when comparing the modest savings (5 to 10%, Thiebaud, Tr. 6990) of about 25¢ to $1 per month that a small $5 to $10 per month toll user can achieve by switching carrier selection, small users would likely consider that the right choice would be to remain with AT&T-C. It appears that AT&T-C has made the right choice to only inform such customers of rate reductions or other service enhancements and not dwell on the availability of competitive service or carrier selection.

It also appears that in 1986 AT&T spent only modest amounts reaching the majority of its residential and small business

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13 [47% + 29.7% (100% - 47%)] = 62.7%.

14 Notwithstanding Fuller's testimony that the other IECs were willing to reimburse customers for the LEC's conversion charges, there appears to be little additional "churn" activity generated by such offers. As an example, the full year estimate of churn for 1987, projected by Pacific Bell, was 4.8%, based on 3.2% churn experienced during the first nine months of 1987. This churn rate does not mean that these percentages of customers are lost from AT&T-C, but merely the percentage of customers who switch IECs, and it includes many who switch to AT&T-C from other IECs. It appears that AT&T-C holds its own on churn, with about three out of four customers selecting and/or reselecting AT&T-C as a carrier of choice (Tr. 7035).

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Therefore, when comparing the modest savings (5 to 10%, Thiebaud, Tr. 6990) of about 25¢ to $1 per month that a small $5 to $10 per month toll user can achieve by switching carrier selection, small users would likely consider that the right choice would be to remain with AT&T-C. It appears that AT&T-C has made the right choice to only inform such customers of rate reductions or other

14 [47% + 29.7% (100% - 47%)] = 62.7%.

15 Notwithstanding Fuller's testimony that the other IECs were willing to reimburse customers for the LEC's conversion charges, there appears to be little additional "churn" activity generated by such offers. As an example, the full year estimate of churn for 1987, projected by Pacific Bell, was 4.8%, based on 3.2% churn experienced during the first nine months of 1987. This churn rate does not mean that these percentages of customers are lost from AT&T-C, but merely the percentage of customers who switch IECs, and it includes many who switch to AT&T-C from other IECs. It appears that AT&T-C holds its own on churn, with about three out of four customers selecting and/or reselecting AT&T-C as a carrier of choice (Tr. 7035).

We are now faced with arguments in equity regarding the suitable base year. Ideally, we would have determined the reasonableness of a particular representative base year and then inflated it as Therrien suggested. However, the public policy and market structure upheavals that AT & T-C faced from 1984 to 1986 all influenced marketing expenses directly. We agree that 1984 was a start-up year for the new AT & T-C's marketing organization, but 1985 and 1986 featured extensive equal access marketing efforts that have in large measure since subsided. In reviewing the three years, no one stands out as representative of "business as usual".

We note that customers will choose the more attractive option when given a choice, and AT & T-C success at marketing could indicate a certain increase in customer satisfaction. Competitive responses to such efforts could benefit customers of all IECs.

In this light, we are still faced with the task of considering AT & T-C's 1984 and 1985 marketing expenditures and establishing a reasonable value for ratemaking. While we accept AT & T-C's characterization of 1984 as a start-up year, we also find merit in the contentions of DRA and TURN that equal access activities in 1985 rendered it as something of a peak for marketing expenditures (especially when noting the need for adopted 1986 values to serve for 1987 and 1988 as well). One choice left open to us is to adopt AT & T-C's 1985 actual expenses along with the carrier selection adjustment proposed by DRA's Fok (as AT & T-C outlines at page 9 of its comments to the proposed decision).

While we find some merit in this compromise, we still believe that 1985 expenses were unrepresentatively high even with this adjustment. Instead, we will make an equitable choice to average 1984 (as a valley) and 1985 with Fok's carrier selection adjustment (as a peak) to determine the reasonable marketing expenses for AT & T-C for test year 1986. The adopted value (adjusted for inflation) is thus $51.1 million on an intrastate basis.

customers based on Fuller's responses (Tr. 7050-7051 and Ex. 252, p. 1).

Having extrapolated that only a small amount of marketing funds are being devoted to the majority of AT&T-C's customers, the question remains as to how the bulk of this marketing budget is used and what overall customer benefits result. While direct evidence is somewhat sketchy, it does appear that AT&T-C is applying the majority of its marketing activities and budget to retain its larger commercial (business and industrial) accounts, and to recapture some of the business that has been lost to other competing IECs. Since AT&T-C has 80%+[15] of the interexchange business, we must "on balance" weigh the widely divergent views of the parties regarding any changes in the previously adopted marketing allowance for AT&T-C for test year 1986.

In doing so we question the reasonableness of authorizing additional marketing costs to be borne by a broad base of small, medium, and large toll telephone ratepayers, to retain or expand AT&T-C's base of large commercial and industrial toll users in the face of mandated competition which is especially targeted to these customers.

Based on all of the foregoing, we again conclude that the $104,230,000 allowance for AT&T-C's test year 1986 marketing activities on a total California basis ($44.7 million on an intrastate basis) is an adequate amount which represents a de facto sharing of the overall marketing expenses between ratepayers and shareholders as we previously noted in D.86-11-079 (mimeo. p. 90).

We will adopt TURN's recommendation and "direct AT&T-C to produce better justification in its next proceeding." [that its

15 Finding 8 at page 213 of D.86-11-079 stated that AT&T-C had "an approximate 82% market share."

In adopting this recommendation we again affirm, as we stated in D.84-06-111 at page 96 (mimeo.) that:

> "The Commission does not consider ratios based on revenues appropriate for the purpose of establishing revenues, because, among other considerations, of the introduction of the circular reasoning aspect."

Also, in D.86-11-079 Ordering Paragraph 3 on page 229 (mimeo.) we directed that:

> "In future rate proceedings, if AT&T-C wishes California ratepayers to bear a share of allocated advertising and marketing expenses, it shall present a cost/benefit analysis in its direct showing, over the latest available 12-month recorded period, as well as its pro forma analysis of future commercial expenses."

This requirement continues to appear sound and reasonable with the proviso that the cost/benefit analysis should be developed to give attention to small, average, and large use customers. The use of a direct allocation and specific cost/benefit analysis should help to set aside the question of the reasonableness of revenues as a proper allocation factor which we have previously questioned.

XI. Reporting Requirements

During the course of its audit, DRA repeatedly claimed that it had difficulties reconciling the costs and benefits of the functions, activities, sales, and return on investment associated with home office and affiliated transactions as charged to AT&T-C. DRA also had concerns regarding the actual in-service dates for the various billing and collection program functions and the beginning and ending dates for various corporate reorganizations.

service enhancements and not dwell on the availability of competitive service or carrier selection.

It also appears that in 1986 AT&T spent only modest amounts reaching the majority of its residential and small business customers based on Fuller's responses (Tr. 7050-7051 and Ex. 252, p. 1).

Having extrapolated that only a small amount of marketing funds are being devoted to the majority of AT&T-C's customers, after initial carrier selection, the question remains as to how the bulk of this marketing budget is used and what overall customer benefits result. While direct evidence is somewhat sketchy, it does appear that AT&T-C is applying the majority of its marketing activities and budget to retain its larger commercial (business and industrial) accounts, and to recapture some of the business that has been lost to other competing IECs. Since AT&T-C has 80%+[16] of the interexchange business, we must "on balance" weigh the widely divergent views of the parties regarding any changes in the previously adopted marketing allowance for AT&T-C for test year 1986.

In doing so we question the reasonableness of authorizing additional marketing costs to be borne by a broad base of small, medium, and large toll telephone ratepayers, to retain or expand AT&T-C's base of large commercial and industrial toll users in the face of mandated competition which is especially targeted to these customers.

AT&T-C in its May 31, 1988 comments dwells at length on the activities and marketing efforts in 1984 and 1985 pointing to its very substantial efforts at reaching all customers (including residential and small business customers) and the need to carry out

16 Finding 8 at page 213 of D.86-11-079 stated that AT&T-C had "an approximate 82% market share."

these activities prior to and during IEC selection balloting. This major one-time effort for initial IEC selection activity is not a proper basis for determining the appropriate level of marketing expenses for a normalized test year 1986 (and years 1987 and 1988 until the next normal rate case cycle). While 1986 activities did include marketing efforts directed to customers who were still making their first IEC of choice selection, Thiebaud confirmed, as earlier noted, that a large majority of this equal access activity had been completed by about September 1986. This meant that the major thrust of AT&T-C's marketing effort directed at IEC selection would thereafter taper off. We have accepted DRA's position advanced by Fok that:

> "Beyond 1985, total AT&T-C marketing force counts began a decisively downward trend, as even the Headquarters force counts hit a plateau in 1986 and began a downward trend thereafter as shown in Appendix C." (Ex. 246, p. 7.)

DRA in its June 8, 1988 "Late-Filed Reply Comments" also stressed the accuracy of Fok's portrayal of employee force counts for 1984 to 1987 and AT&T's reorganization plan to cut staffing costs in 1986. DRA also drew attention to Fok's belief that salaries comprised the bulk of AT&T-C's marketing expenses.

It is an accepted fact that AT&T-C's 1986 recorded marketing expenses were reported to be higher than 1985.

However, in adopting a reasonable marketing level of $104.23 million as adequate for 1986 we are also allowing a similar level for 1987 and 1988 or $312.69 million for the three-year normalized period between major rate proceedings. It is undisputed, in the record evidence, that the marketing costs of initial carrier selection were not significant beyond 1986 (1987 and 1988). Also, as noted earlier therein, over 62% of AT&T's residential and 32% of its business customers, as small users of AT&T-C's toll services, were no longer being targeted for significant marketing efforts after intitial carrier selection. This leaves significant portions of the marketing funds in 1987, and beyond, available for AT&T-C to target, as needed, the more competitive portions of its interexchange business.

TURN in its June 8, 1988, "Late-Filed Reply Comments" stresses that AT&T-C's marketing focus is clearly on the large commercial customer. TURN calls attention to the fact that 1986 business account expenditures exceed those of residential accounts and the discrepancy on a per account is obviously far greater.

We are satisfied that there is no reasonable record evidence to support a showing of a need for an increase in marketing allowance for test year 1986, beyond the $104.23 million heretofore adopted in D.86-11-079.

Based on all of the foregoing, we again conclude that the $104,230,000 allowance for AT&T-C's test year 1986 marketing activities on a total California basis ($44.7 million on an intrastate basis) is an adequate amount which represents a de facto sharing of the overall marketing expenses between ratepayers and shareholders as we previously noted in D.86-11-079 (mimeo. p. 90).

We will adopt TURN's recommendation and "direct AT&T-C to produce better justification in its next proceeding." [that its marketing expenditures provide a proven cost benefit to its small, average, and large use customers] (TURN Br., pp. 2 and 3).

In adopting this recommendation we again affirm, as we stated in D.84-06-111 at page 96 (mimeo.) that:

> "The Commission does not consider ratios based on revenues appropriate for the purpose of establishing revenues, because, among other considerations, of the introduction of the circular reasoning aspect."

Also, in D.86-11-079 Ordering Paragraph 3 on page 229 (mimeo.) we directed that:

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XI. Reporting Requirements

During the course of its audit, DRA repeatedly claimed that it had difficulties reconciling the costs and benefits of the functions, activities, sales, and return on investment associated with home office and affiliated transactions as charged to AT&T-C. DRA also had concerns regarding the actual in-service dates for the various billing and collection program functions and the beginning and ending dates for various corporate reorganizations.

Many of DRA's concerns were related to allegedly incomplete data responses and/or lack of specificity in the accounting records provided to DRA for auditing purposes. Considerable time was used both on and off the formal record in an attempt to reconcile differences between AT&T-C and DRA relative to the information DRA needed to present its evidentiary showing.

By addressing the specific issues raised by DRA as we have throughout its order, it may be possible for AT&T-C to plan and use better record-keeping and provide certain periodic reports to DRA to assist it, in a more orderly and less cumbersome analysis for any future rate proceeding, or investigation, before this Commission.

As we recap, in Appendix D to this order, the reporting requirements that we have adopted, we are mindful of AT&T-C's views and arguments that we not overburden it with the retention and presentation of voluminous data not ordinarily developed, maintained, or required in the ordinary course of its business, and especially that of its non-utility affiliated operations.

Therefore, in Appendix D, we will limit the scope of periodic reports and emphasize necessary memorandum record-keeping to allow AT&T-C to present the data needed by DRA in connection with any future rate proceeding.

<u>Findings of Fact</u>

1. Review of DRA's audit report was the main thrust of this proceeding; therefore, DRA made the initial presentation of all issues in the Phase II hearings and its position is routinely discussed first in this order; nonetheless, the burden of proof for the reasonableness of all expenses rests with AT&T-C under PU Code Section 454.

2. AT&T began a major corporate reorganization in 1986 which will affect nearly every part of its operations when it is fully implemented.

Many of DRA's concerns were related to allegedly incomplete data responses and/or lack of specificity in the accounting records provided to DRA for auditing purposes. Considerable time was used both on and off the formal record in an attempt to reconcile differences between AT&T-C and DRA relative to the information DRA needed to present its evidentiary showing.

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Therefore, in Appendix D, we will limit the scope of periodic reports and emphasize necessary memorandum record-keeping to allow AT&T-C to present the data needed by DRA in connection with any future rate proceeding.

XII. Refunds of Overcollections by AT&T-C

1. Background and Responses to ALJ's Request for Comments

Ordering Paragraph 18 of D.86-11-079 directed that the rates established by that decision, "...will be collected subject to refund, until a final decision is rendered in this 1986 test year proceeding." Thereafter, by various other decisions this Commission has ordered reductions in access charges and other expenses which have reduced AT&T-C's costs of operations. The savings from these reduced costs of operations have not been reflected in rates and thus result in accumulated overcollections of $163.6 million[17] annually over existing rate levels until AT&T-C's rates are reduced to reflect current expenses. (AT&T-C's May 31, 1988 response to ALJ's request regarding refunds.) In addition, another $21.5 million has been accrued by AT&T-C from expense reductions for periods prior to January 1, 1988.

Lastly, since the interim rates established by D.86-11-079 were made subject to refund pending this Phase II order, AT&T-C will be required to refund to its ratepayers an additional $15.6 million as of July 1, 1988 due to the final disposition of this proceeding (A.85-11-029).

The total amount available for refund as of July 1, 1988 is approximately $118.9 million[18] based on the data noted above.

To prevent further accrual of overcollections by AT&T-C, rates must be reduced to bring them in line with current costs. This can be done by reducing current rates by $174.0 million annually.[19] An overall rate reduction of about 9.983% effective July 1, 1988 would bring rates into line with the current costs of operation adopted herein.

AT&T presently has a +.986% surcharge on its California intrastate interLATA toll rates. Elimination of that rate

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17 The accumulated overcollections at July 1, 1988 would be 1/2 this amount or $81.8 million.

18 $81.8 million + $21.5 million + $15.6 million = $118.9 million.

19 $163.4 million annual reductions for D.87-12-067, D.87-12-070, D.87-12-051, D.87-10-088, and D.88-10-061, and $10.4 million for revenue requirement reductions adopted herein.

savings from these reduced costs of operations have not been reflected in rates and thus result in accumulated overcollections of $163.6 million[14] annually over existing rate levels until AT&T-C's rates are reduced to reflect current expenses. (AT&T-C's May 31, 1988 response to ALJ's request regarding refunds.) In addition, another $21.5 million has been accrued by AT&T-C from other miscellaneous expense reductions.

Lastly, since the interim rates established by D.86-11-079 were made subject to refund pending this Phase II order, AT&T-C will be required to refund to its ratepayers an additional $6.6 million as of July 1, 1988 due to the final disposition of this proceeding (A.85-11-029).

The total amount available for refund as of July 1, 1988 is approximately $109.9 million based on the data noted above.

To prevent further accrual of overcollections by AT&T-C, rates must be reduced to bring them in line with current costs. This can be done by reducing current rates by $168.0 million annually.[15] The assigned ALJ asked the parties to specifically address their comments or concerns regarding his proposed order to reduce rates to a current cost basis and to refund overcollections effective July 1, 1988, and whether these directives fulfill the requirements of PU Code § 453.5. He also directed the parties' attention to Kenneth Cory v Public Utilities Commission et al. (1983) 33 C 3rd 527, wherein the California Supreme Court cited its earlier opinion in California Mfrs. Assn. v Public Utilities

14 The accumulated overcollections at July 1, 1988 would be 1/2 this amount or $81.8 million.

15 $163.4 million annual reductions for D.87-12-067, D.87-12-070, D.87-12-051, D.87-10-088, and D.88-10-061, and $10.4 million for revenue requirement reductions adopted herein.

surcharge coupled with an 8.997% rate reduction would reduce AT&T-C's intrastate rates to a current cost basis.

A minor rate reduction, of about 1.485%, is also needed to bring AT&T-C's intrastate private line rates in line with current costs as later discussed herein.

The assigned ALJ asked the parties to specifically address their comments or concerns regarding his proposed order to reduce rates to a current cost basis and to refund overcollections effective July 1, 1988, and whether these directives fulfill the requirements of PU Code § 453.5. He also directed the parties' attention to Kenneth Cory v Public Utilities Commission et al. (1983) 33 C 3rd 527, wherein the California Supreme Court cited its earlier opinion in California Mfrs. Assn. v Public Utilities Commission (1979) 24 Cal. 3rd 836, for review in preparing their comments.

2. AT&T-C's Position

AT&T-C filed a separate detailed response to the ALJ's specific request. In its response AT&T-C stated that its refund plan should not be delayed until the final resolution of this rate case. AT&T-C then called attention to the fact that on May 20, 1988 it filed Advice Letter 97 seeking authority to reduce its current rates effective July 1, 1988 in order to flow through all past expense reductions heretofore ordered in the following five decisions:

o D.87-12-067	Pacific Bell	O.P. 35 & 38
o D.87-12-070	GTE California	O.P. 1 & 2
o D.87-12-051	Pacific Bell	O.P. 3
o D.87-10-088	ULTS (Tracking)	O.P. 2
o D.88-01-061	Tax Reduction Act	O.P. 1A

AT&T in its comments opined that if it must defer all refunding until final resolution of this rate case, it could not meet the July 1, 1988 proposed target date. Therefore, AT&T-C asks that its Advice letter 97 be approved expeditiously and that any

4. Discussion

The question of how to convey the monies that have accrued in AT & T-C rate overcollections is a complicated one that requires careful consideration. We are, on the one hand, faced with a substantial memorandum account and a utility (AT & T) willing to distribute it to ratepayers via an immediate rate reduction. Alternatively, competitors and certain customers urge us to offer lump-sum refunds and leave rates more or less at current levels. We undertake this analysis in the context of a competitive market whose dominant firm is herein being reviewed for perhaps the last time as if it were a monopoly; in this context, we have labored diligently to assess the reasonableness of expenditures whose disallowance again lowers competitive rates. Certain parties have argued both for refunds (which would keep rates higher) and for disallowances (which would lower rates).

We did not expect such difficulties when we decided to consolidate a series of access charge reduction flow-throughs into one rate adjustment. Rather than ordering immediate AT & T-C rate adjustments for each change in local exchange access charges, we ordered that a memorandum account be kept, with interest, to be reflected in AT & T-C's rates upon our order. We did this to minimize customer confusion regarding frequent rate adjustments and to minimize the administrative costs to all concerned (regulators, customers, and AT & T-C). We anticipated that this memorandum account might contain increases as well as decreases, depending upon the outcomes of the various local exchange decisions upon which the access charge changes would be based; indeed, we refrained from labeling this a balancing account solely to minimize the accounting and financial reporting issues that such a designation would raise. We also expected this account to be eliminated expeditiously, and today's action does so.

Over a period of months these monies have accumulated rapidly. The question now is whether to depart from our original additional rate adjustments which may arise from this proceeding be considered and implemented by a surcharge following the issuance of a final order in this proceeding (AT&T-C Comments, p. 2).

A careful review of AT&T-C's Advice Letter 97, appended to its comments, reveals that its proposal would substantially reduce its intrastate toll rates for the six-month period July 1 through December 31, 1988. It would also apply a modest surcredit to its private line services for the same period. The rate impacts of Advice Letter 97 (if adopted) would be approximately as follows:

- o Reduction/Surcredit for July 1988 only with an effective rate reduction of 44% on Switched Services, and a Surcredit of approximately 3% on Private Line, and a
- o Reduction/Surcredit for August 1, 1988 to December 31, 1988 with a rate reduction of 23% on Switched Services, and a Surcredit of approximately 3% on Private Line.

These impacts do not include effects of this Phase II decision in A.85-11-029. The change would be nominal in any case (2% or less).

The benefits of AT&T-C's Advice Letter 97 rate reductions would be entirely prospective and apply to message toll and private line services rendered from July 1, 1988 through December 31, 1988.

AT&T-C believes that its Advice Letter 97 fulfills the requirements of PU Code § 453.5 and is consistent with decisions of the California Supreme Court. AT&T-C comments that:

> "Section 453.5 provides that 'Whenever the commission orders rate refunds to be distributed, the commission shall require public utilities to pay refunds to all current utility customers, and, when practicable, to prior customers, on an equitable pro rata basis...' (emphasis added).
>
> "AT&T's intended distribution to all current customers (residential as well as business) is consistent with this Section. Indeed, any required distribution to prior customers, residence or business, as far back as March,

intention to reflect these access charge cost reductions in rates on a going-forward basis, or whether to accept any of the arguments presented in favor of an alternative treatment.

We should first note that we have carefully reviewed the legal issues raised by the cases of California Manufacturer's Association v. Public Utilities Commission (1979) 24 Cal. 3d 836 and Cory v. Public Utilities Commission (1983) 33 Cal. 3d 522, and we do not find them constraining upon our ability to proceed with a wholly prospective rate adjustment for AT & T-C. Specifically, the California Manufacturer's Association case (from which Cory follows) involved supplier rebates returned to the utility for service delivered several years in the past. There are no supplier rebates here, nor do the access charge reductions date back longer than a matter of months.

AT & T-C's competitors argue for a retrospective refund, presumably with the intent of facing higher competitive long distance prices than would obtain with a prospective adjustment. The competitors assert that a prospective reduction would be anticompetitive.

However, we must note that all interexchange carriers have received the benefits of the access charge reductions; the amounts accrued in AT & T-C's memorandum account have been paralleled by proportionately similar access charge reductions received by all interexchange carriers. For some months we have kept AT & T-C's rates above the level that these reductions would have permitted; its competitors have presumably either passed through some of their savings in lower rates to attract customers, or retained their savings and kept rates close to AT & T-C's (in which case the accumulated savings will be available for competitive responses to an AT & T-C reduction). In either case, AT & T-C and its interexchange competitors will have been on an even footing in regards to their access charges and ability to maintain comparable rate levels for the entire period in question (excepting, of

> 1986, would be cost-prohibitive and, in many instances, simply impossible. Since commencing business on January 1, 1984, virtually all the message toll billing for AT&T's intrastate interLATA services in California has been performed by the state's 24 local exchange companies; the records and data associated with this billing function are neither maintained nor controlled by AT&T. To require these 24 local exchange companies to identify and analyze the usage of all AT&T customers over the past two years in order to calculate refunds based on that prior usage would require an enormous work effort and would cost AT&T, and ultimately its ratepayers, nearly as much as the refund itself." (AT&T-C Response to ALJ Request, pp. 3 and 4.)

AT&T-C also estimated that the task of reviewing customer bills back to March 1986 and a separate calculation of each interLATA toll charge together with the preparation of refund checks to each prior customer would involve about three million man-hours of effort at a cost of more than $90 million.

AT&T-C contends that: "As a practical matter, the work force needed to complete this job in a reasonable period of time simply does not exist."

AT&T-C also comments that:

- Many of the LECs do not maintain billing records for longer than 90 days.
- Pacific Bell and General Telephone Company of California (General) were specifically excused by the Commission in D.91337, pp. 44-45 from refunding to any prior residential customers--on the basis that it would be extremely costly, time consuming, and unsuccessful.
- The Commission determined that a strict retroactive refunding requirement on the part of General--even with respect to its business customers would be impracticable and therefore not required under PU Code § 453.5.

course, the competitors' own costs, which are their business). We are therefore satisfied that the competitive implications of a prospective rate adjustment are reasonable.

Certain large customers note that they might benefit more from a proportional refund granted on the basis of prior use rather than by a prospective rate reduction. Even if true, this argument is not persuasive given the brief time these rate reductions have been postponed. The arguments by the California Association of Long Distance Telephone Companies regarding the direct assignment of WATS by this Commission and the FCC raise the issue of customers that may have discontinued prior use of AT & T-C in part due to other regulatory decisions. However, the migration away from AT & T-C service is asserted to have occurred during 1986 and 1987, while the access charge reductions at issue here were added to the memorandum account in 1988. Had we not employed the memorandum account, the access charge reductions would have been passed into AT & T-C's rates after these customers had already left AT & T-C.

AT & T-C's position as an interexchange carrier that bills the majority of its customers through local exchange operating companies is another factor in this decision. Because these local exchanges do not retain AT & T-C billing records for more than 90 days, it is not practicable to require a refund to all customers based on earlier billing. AT & T-C's comments make this fact clear in estimating that three million man-hours might be required to make such refunds; while we are unsure as to the exact magnitude of the required effort, it is clear that such an effort could easily exhaust the balance of the memorandum account. We are not convinced that refunds based on immediate past usage (i.e., up to 90 days) have much to recommend them over a rate adjustment based on usage in the present and in the immediate future. Given the impractibility of going back more than 90 days, we would expect a going-forward rate adjustment to perform almost as well as a refund in matching prospective rate reductions to the savings those same

- Attempting to identify and track the prior toll usage of AT&T-C's long distance customers during the period of "inter-exchange carrier selection" adds a refund complexity never before addressed by this Commission.

AT&T-C then cited four other advice letters that it filed with this Commission to distribute overcollections to current customers based on current [prospective] usage; these were:

- Advice Letter 30, effective October 29, 1984,
- Advice Letter 66, effective September 1, 1986,
- Advice Letter 83, effective July 1, 1987, and
- Advice Letter 90, effective January 1, 1988.

Lastly, AT&T-C stresses that its proposed "...refund plan is also consistent with the California Manufacturers' decision." [California Manufacturers Association v PUC (1979) 24 Cal. 3d 836.] In that case, according to AT&T-C, the California Supreme Court held that the Commission had exceeded its authority when it "distributed" supplier rebates to utility balancing accounts (as an offset against prospective rate increases), rather than refunding in accordance with PU Code § 453.5. The Court was not asked under those circumstances whether retroactive refunding was either cost-prohibitive or practical. AT&T-C also called attention to the Court's instructions to the Commission relative to refunds and then summarized its position for this proceeding as follows:

> "The Court further stated that in formulating a refund plan, the Commission should be, '...mindful of section 453.5's admonition that the obligation to provide pro rata refunds based on past usage is limited by considerations of practicality.' (Id. at 848.) The Court further instructed that '...where a statute is theoretically capable of more than one construction, [the Court] will choose that which most comports with the intent of the Legislature...'" (Id. at 844.)
>
> "Accordingly, the Commission has full authority, within the requirements of Section 453.5, to

customers would have received had we lowered AT & T-C's rates as each access charge adjustment occurred.

Finally, we are bound to ask whether the needs of customers are better served by a refund or by a substantial rate reduction. We have found before that a rate reduction will stimulate greater volumes of calling; these additional calls create benefits to consumers that they would not otherwise receive if rates were to remain near current levels. We believe that most customers will prefer to make more future calls at cheaper rates instead of receiving a one-time refund based on recent use.

Given our preference for a rate reduction, we must determine its specific form. AT & T-C's Advice Letter 97 proposes a special July surcharge in addition to a substantial rate reduction that would take effect for the remainder of the year. We see no reason to cut rates dramatically one month followed by a substantial increase the next; this would create some of the administrative cost and customer confusion we sought to avoid by consolidating the access charge pass-throughs into one rate adjustment. Instead, we will reject Advice Letter 97 and order AT & T-C to implement a uniform percentage reduction for switched services to be effective from July 1, 1988 until the end of the year. This reduction should include the effects of amortizing the memorandum account as well as the rate impacts associated with the findings in this decision. The effects of previously experienced expense reductions should be applied to produce a uniform six-month surcredit, while ongoing reductions in the authorized revenue requirement should be applied to reduce rates. For private line services, AT & T-C should use the approach followed in Advice Letter 97 to bring rates in line with costs.

<u>Findings of Fact</u>

1. Review of DRA's audit report was the main thrust of this proceeding; therefore, DRA made the initial presentation of all issues in the Phase II hearings and its position is routinely

consider the complex circumstances and practical limitations in connection with AT&T's proposed refund. AT&T's plan -- which will refund all prior expense savings to present customers on the basis of current usage -- is both reasonable and practicable; it is consistent with the decisions of the California Supreme Court; and will fulfill the basic underlying requirement of Section 453.5 that all such refund distributions must be made on an 'equitable pro-rata basis.'" (AT&T-C Response to ALJ Request, pp. 9 and 10.)

AT&T-C in its Late-Filed Reply comments dated June 8, 1988 responded to other parties' charges that its Advice Letter 97 would set predatory and anticompetitive rates as follows:

"U.S. Sprint, MCI, CALTEL, and DRA argue that AT&T's plan to distribute the Commission's previously ordered expense reductions to current customers based on current usage is anticompetitive and violates Section 453.5 of the Public Utilities Act. The protestants are wrong on both counts.

"First -- with respect to the potential competitive impact of AT&T's planned refund - it is critical to remember that the access charge reductions and tax savings which constitute the primary bases for these refunds have been enjoyed proportionally by all interexchange companies (IECs), including MCI and U.S. Sprint. The Commission's SPF to SLU access charge reduction plan clearly anticipates that all resulting expense savings realized by IECs will be passed along to their customers in interexchange rate reductions, thereby reducing the potential for uneconomic bypass of the local exchange network.

"Although both MCI and Sprint have expressed concern over the manner in which AT&T proposes to refund its expense savings, both companies have had -- and will continue to have -- the same opportunity as AT&T to pass these access charge reductions and tax savings along to their customers..." (AT&T-C June 8, 1988 Reply Comments, p. 5.)

3. Other Parties' Positions on ALJ's Proposed Refund Plan

DRA, CALTEL, MCI, TURN, and U.S. Sprint all filed comments regarding the proposed refund plan and all were opposed to the method recommended by AT&T-C in Advice Letter 97.

a. DRA Comments on Refunds

Referring to Cory v PUC, DRA contends that:

> "The Cory decision specifies that the statutory formula contained in Public Utilities Code Section 453.5 must be used to distribute refunds. Under Cory, present customers must be compensated on the basis of prior usage to which the refund corresponds, and, where practical, prior customers must also participate to the extent of the overcharges which they previously paid.
>
> "AT&T-C's May 20th Advice Letter No. 97 proposed to refund in two steps. First, rate reductions ordered prior to January 1, 1988 will be accomplished by a negative surcharge for the month of July, 1988. Second, rates will be reduced for a period of six months from July 1 - Dec. 31, 1988 to reflect 1988 access charge reductions.
>
> AT&T-C proposes to reduce rates of present customers regardless of present or past usage and regardless of whether a present customer was a customer for the period in which refunds apply. This is not a refund plan, it is a proposal to reduce rates in lieu of refunds and clearly violates the Cory decision.
>
> "This proposed refund plan would invite customers of interLATA competitors to switch to AT&T-C to obtain rate reductions of approximately 40% for a period of six months. Such Commission-approved tampering with the interLATA market to the benefit of AT&T-C is untenable." (DRA May 31, 1988 Comments, pp. 1 and 2.)

DRA then stated that it will request that Advice Letter 97 be suspended pending the issuance of a final decision in this proceeding. On June 8, 1988 DRA filed its request to Suspend Advice Letter 97.

On June 8, 1988 DRA as a part of its "Late-Filed Reply Comments" recommended that the Commission use, "...the existing 90 days usage data available to AT&T-C with weighting factors to compensate for the exact period within which refunds were due.", for computing one-time refunds. In addition, DRA recommended that approximately one-tenth of the amount be reserved for prior customers who may have left the company. DRA also recommends that public notice of ordered refunds be required; such notice would state "...when, where and how a prior customer could claim, prove and receive any refund to which he/she is entitled." (DRA June 8, 1988, Late-Filed Comments, p. 7.)

b. CALTEL Comments on Refunds

In its filed comments, CALTEL recommended that the advice letter filed pursuant to the revenue requirement determination in this proceeding "...only reflect [AT&T-C's] post-July 1988 revenue requirement." Any overcollection occurring prior to that date should be refunded pursuant to the Refund Plan filed pursuant to this order. "That Refund Plan, in turn, should provide for direct refunds to existing customers (and, where practical, prior customers) based on those customers' usage during the period March 1986 - to the effective date of the rates implemented..." in this proceeding. (CALTEL May 31, 1988 Comments, p. 2.)

CALTEL also directs attention to the fact that many of the IECs as "pure" resellers were permitted, in the past, to use lower cost exchange facilities for originating access rather than being required to use more expensive feature group facilities from the LECs. By D.85-06-115 and Federal Communications Commission (FCC) Docket 86-1, this Commission and the FCC began to require all IECs to purchase originating access services out of the LEC's

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access tariffs and to not receive any credits reflecting WATS usage. As a result many IECs that employed WATS during 1986 and 1987 are no longer users of WATS or any other service from AT&T. "These IECs cannot, therefore, receive any refunds distributed as future reductions."

CALTEL stresses that:

> "The IEC WATS customers of AT&T stand in the same shoes as the large natural gas users described in California Manufacturer's Association v. Public Utilities Commission (1979) 24 CAL 3d 386, 157 Cal. Rptr. 676. Those natural gas users had paid overcharges during particular years and then substantially left the gas system prior to the period that the benefits of supplier refunds, which were to be passed into future rates through adjustments to a balancing account, would be placed into effect. The CMA holding is described in Kenneth Cory v. Public Utilities Commission (1983) 33 Cal. 3d 522, 189 Cal. Rptr. 386."

c. MCI Comments on Refunds

In its comments MCI urged the Commission adopt a one-time refund which in its view is required by PU Code § 453.5. MCI contends that in addition, "The statute, as interpreted by the courts, expresses a strong public policy favoring the distribution of refunds back to the same customers who paid the revenues to the utility in the first place. In fact, the statutory allocation of refunds requires that current customers must be compensated on the basis of their prior usage." (MCI May 31, 1988 Comments, p. 2.)

MCI also urges the Commission to take care, "...that the prices which utilities charge reflect current costs, and thus send the proper price signals to customers. If it does otherwise, consumption and investment decisions will be skewed inappropriately, and AT&T would be granted an artificial market advantage." (MCI May 31, 1988 Comments, p. 3.)

MCI summarized its May 31, 1988 comments on refunds as follows:

> "No one should be heard to complain if [AT&T-C's] prices reflect current costs, including access, other internal costs and a reasonable return. But a six month refund plan, for example, could easily result in prices for that period of time which would fall well below those costs. Under those circumstances the Commission would be sanctioning unlawful, predatory pricing, and would assure that AT&T's competitors would be unprofitable for that period of time. Such a result may well be consistent with AT&T's shareholders best interests, but it would not serve the public interest. The Commission should take care that no refund plan permit [AT&T-C] to design rates which would fall below [AT&T-C's] then-current costs." (MCI May 31, 1988 Comments, p. 4.)

On June 8, 1988, MCI submitted Late-Filed Reply Comments which buttressed its position in opposition to prospective rate reductions in lieu of one-time refunds, and provided additional support for the comments earlier submitted by DRA and U.S. Sprint discussed herein.

d. <u>U.S. Sprint Comments on Refunds</u>

U.S. Sprint opined that the Commission's careful evaluation of the filed comments is crucial, because the way the refund process is structured and implemented could affect the state of competition in the IEC industry for some time in the future.

U.S. Sprint detailed its support for a one-time refund instead of the AT&T-C's prospective rate adjustment contained in Advice Letter 97. U.S. Sprint contends that in that advice letter AT&T-C proposes six months of rate decreases for only current customers in lieu of a refund. "This type of proposal is anticompetitive and predatory. The Commission should reject AT&T's proposal because it proposes below cost predatory pricing which will negatively affect competition during a crucial transitional phase; it attempts to lock in customers by offering below cost rates for a sustained period which are cross-subsidized from above cost rates offered during an earlier period; and it discriminates between customers by failing to distribute any refund to former customers. (U.S. Sprint May 31, 1988 Comments, p. 2.)

U.S. Sprint asserts that AT&T-C's Advice Letter 97:

> "...forces current customers to remain with AT&T during a six month period to obtain the full refund due the customer."
>
> * * *
>
> "What AT&T really is doing, in trying to win the game, is requesting that the Commission allow it to offer below cost prices to its current customers in the last half of the year, with those rates cross-subsidized by the over-cost prices of the first half of the year. Not only is this type of refund unfair, because customers owed refunds will not receive them, but it is illegal.
>
> "AT&T should be ordered to refund the money to customers owed it, both current and previous, on a one time lump sum basis. To deny refunds to previous customers constitutes rate discrimination between classes of customers in violation of Section 453.5 of the California Public Utilities Code which indicates, in relevant part, that
>
> > 'Whenever the commission orders rate refunds to be distributed, the commission shall require public utilities to pay refunds to all current utility customers, and when practicable to prior customers, on an equitable, pro rata basis...in proportion to the amount originally paid for the utility service involved, or in proportion to the amount of such utility service actually received.'
>
> "Those customers who purchased AT&T services in early 1988 but now are purchasing services from other carriers will pay more

> for the early 1988 AT&T services than customers who remain with AT&T. This form of rate discrimination is very invidious, because it is designed to impose exit penalties on customers who switch to other carriers. This anticompetitive rate discrimination should not be permitted by this Commission." (U.S. Sprint May 31, 1988 Comments, pp. 3 and 4.)

U.S. Sprint summarized its comments stating that the refund not be tied to current customers' prospective rates because the adjustment of prospective rates for accomplishing a refund has,

> "...the strong potential to discriminate against some classes of customers, allows predatory below cost pricing subsidized by earlier above costs rates, and permits AT&T to 'lock-in' customers during a crucial transition period in the interexchange industry. For all practical purposes, the Commission needs to play its public interest role as a referee, and call 'foul' to AT&T's game plan. The Commission is entrusted with and empowered to create the rules of this game. U.S. Sprint respectfully requests that the Commission makes sure that the rules are fair, that AT&T plays by them, and that all players have the opportunity to compete." (U.S. Sprint May 31, 1988 Comments, pp. 6 and 7.)

In its Late-Filed Reply Comments U.S. Sprint stressed that AT&T-C has not demonstrated why it should be allowed to distribute the money that lawfully belongs to former large customers to its current customers. U.S. Sprint then requested that AT&T-C's Advice Letter 97 and "...its ill-advised proposal be rejected," and that the Commission require that any refund plan be adequately supported by relevant data and comments by other parties to this proceeding.

e. <u>TURN Comments on Refunds</u>

TURN by its May 31, 1988 "Comments" recommended a one-time refund of the overcollections and then chided AT&T-C as follows:

> "The ALJ's recommendation that a one time refund of 'approximately $116 million' be made to [AT&T-C's] customers to flow through results of access charges, Universal Life Line Telephone Service, and Tax Reform Act of 1986 overcollections as well as amounts collected subject to D.86-11-079, should be adopted forthwith. It is not surprising that, separately [AT&T-C] filed an advice letter subsequent to the issuance of this proposed decision that calls for a different distribution. AT&T doesn't give up easily. Neither do consumers." (TURN May 31, 1988 comments, p. 1.)

4. <u>Discussion</u>

We have received clear and consistent recommendations from all parties, other than AT&T-C, that prior overcollections should be returned to the customers who have contributed to those overcollections through a one-time refund. All parties, other than AT&T-C, also agree that prospective rates should be based on current costs.

AT&T-C would instead return the overcollections through rate reductions over the six-month period from July 1 through December 31, 1988, as set forth in Advice Letter 97 discussed earlier herein.

One real issue before us is what constitutes reasonable compliance with PU Code § 453.5 in refunding overcollections to utility customers. The relevant parts of PU Code § 453.5 are:

> "Whenever the commission orders rate refunds to be distributed, the commission shall require public utilities to pay refunds to all current utility customers, and when practicable to prior customers, on an equitable, pro rata basis...in proportion to the amount originally paid for the utility service involved, or in

> proportion to the amount of such utility service actually received."

and

> "Nothing in this section shall prevent the commission from authorizing refunds to residential and other small customers to be based on current usage. (Added Stats. 1977, CH. 897.)

It certainly would not be "practicable" or reasonable to have AT&T-C spend about three million person-hours of effort at a cost of $90 million, to refund about $118.5 million to customers of record for usage beginning March 1986 to the effective date of this order.

However, avoidance of all review of prior customer usage and the setting of future rates at less than cost, to amortize the prior overcollections through rate reductions and prospective use, is even more unreasonable and inequitable for a refund of overcollections of this magnitude. Such a method would send a signal to customers that they must purchase additional service, whether they need it or not, to receive through bargain rates an amount equal to their prior overpayment.

While it can be argued that, for some persons who regularly use AT&T-C's intrastate service at consistent levels, such a method will be reasonable, for others who are variable users it would not be either reasonable, or equitable.

In fact, for some customers who have greatly reduced or terminated their AT&T-C intrastate usage; AT&T-C's proposal would be similar to that of a restaurant owner in a distant town offering a second dinner at half price to satisfy a traveling customer who had discovered that he had substantially overpaid for the first one he had purchased and just eaten. Obviously, the customer in this example would have little use for the second meal and may not benefit from the offer.

AT&T-C's proposal is even more unreasonable from the viewpoint of other competing IECs, since its Advice Letter 97 would reduce intrastate message toll rates by about 44% for July and 23% for August through December 1988. This would be predatory pricing with rates at roughly 35% and 14% below AT&T-C's current costs of service for the same periods.

Whether the IECs could, or could not, match this competition because they too have experienced reductions in access charges is subject to serious debate. It should be noted that the source of the refund amounts includes about $21.5 million in pre-1988 overcollections which were largely the result of changes due to the Tax Reform Act of 1986. Necessarily these other IEC's overall operations are not the same as AT&T-C's and these changes in the tax law would affect them differently than AT&T-C, and any benefits received by them will also differ from those available to AT&T-C.

There must be a reasonable middle ground approach which substantially would avoid these problems and it is our burden to find and implement such a method.

To reasonably solve the problem of terminating and refunding overcollections, we must do two things as follows:

- First, we must reduce AT&T-C's intrastate rates to a current cost of service basis to terminate any further overcollections, and

- Second, we must deal with the refund of existing overcollections on a reasonable basis, that does not involve excessive costs of implementation.

To achieve the first objective, we will direct AT&T-C to eliminate its existing surcharge and reduce its intrastate rates, effective July 1, 1988, to its current cost of service basis as determined in this proceeding.

Next, we will direct AT&T-C to utilize the most recent three months of recorded intrastate usage (billing data) retained by the LECs to determine the proper amount of overcollections to be returned, with interest from July 1, 1988 to the date of refund, to AT&T-C's customers via a one-time credit on their bills for service rendered on and after October 1, 1988.[20]

In developing these one-time refunds using the most recent 90-day recorded billing data, AT&T-C shall hold back 10% of the overcollected amount to satisfy any existing or prior customers who claim that their specific situation warrants a different basis of refund of overcollections, assuming these claimants have retained and presented all the necessary billing data to support their claim.

This 10% hold-back is necessary to respond to requests for refunds of prior customers whose usage of AT&T-C's intrastate service either changed greatly or was discontinued prior to or during the standard three-month period.

We emphasize that the burden of presenting support for these exceptional claims for refunds of past overcollections will rest with AT&T-C's customers, and AT&T-C's responsibility will merely be to check the accuracy of the support for the claim, not for the preparation of the claim itself. Claims for exceptional refunds submitted without supporting billing records should be denied and the standard three-month recorded usage method utilized instead.

While no refund plan that we may choose will satisfy everyone, our choice herein can be implemented at a reasonable cost, avoid the serious issue of predatory pricing raised by the

20 Using data provided by AT&T-C in response to CACD's Data Request 88-04-08C dated April 25, 1988, CACD estimates that the cost of a refund plan employing the most recent three-month recorded billing data as retained by the LECs is less than $2.5 million. This amount does not include costs for notices, bill inserts, or other customer communications and the internal administrative costs of AT&T-C which we believe will be nominal.

interested parties in their comments to the assigned ALJ, and meet as closely as "practicable" the spirit and intent of PU Code § 453.5.

Findings of Fact

1. Review of DRA's audit report was the main thrust of this proceeding; therefore, DRA made the initial presentation of all issues in the Phase II hearings and its position is routinely discussed first in this order; nonetheless, the burden of proof for the reasonableness of all expenses rests with AT&T-C under PU Code Section 454.

2. AT&T began a major corporate reorganization in 1986 which will affect nearly every part of its operations when it is fully implemented.

3. The basic reason for AT&T's reorganization, initiated in 1986, was to cut costs and improve the efficiency and competitive position of AT&T's overall operations.

4. AT&T's overall employee expenses were likely increased for test year 1986 due to AT&T's corporate reorganization.

5. Neither AT&T-C nor DRA furnished full details of the near term future benefits of the reorganization plan or the normalized and annualized present worth of those benefits for the test year.

6. DRA has identified modest specific expense savings due to employee reductions associated primarily with AT&T-C's marketing activities.

7. DRA determined the reorganization savings to be $3.5 million for test year 1986 and applied that amount to AT&T-C's total California marketing activities.

8. DRA did not reduce the $3.5 million proportionately for the adopted versus budgeted marketing allowance.

9. DRA's recommended $3.5 million reorganization adjustment should be proportionately reduced to apply to the authorized rather than budgeted marketing expenses for test year 1986. The resulting statewide reorganization expense adjustment to AT&T-C's marketing activities is $2.3 million, and on an intrastate basis is $1.0 million.

10. This proportional reduction of DRA's reorganization adjustment shares the benefit of reorganization cost savings between AT&T's customers and shareholders based on their separate contributions to the marketing budget as identified elsewhere in this order.

11. DRA's recommended test year 1986 disallowance and deferral of all expenses associated with the development and deployment of AT&T's customer service and billing program, excepting for account inquiry functions, is insupportable based on the record which demonstrated that certain other program functions

to advertising and $104,230,000 to marketing functions for test year 1986.

65. The combined advertising and marketing allowance of $126,623,000 represents $8.90 for each of the state's total estimated 14.2 million access lines, and this should be compared with the last authorized advertising and marketing allowance of $67.5 million which amounted to $5 for each of the estimated 13.5 million access lines in California for test year 1984.

66. D.86-11-079 adopted the amount of $22,393,000 for test year advertising functions, and no further issues were raised in Phase II relative to AT&T-C's test year 1986 advertising budget.

67. D.87-04-041 granted limited rehearing on the marketing issue to allow AT&T-C to present argument as to whether 1985 was more appropriate than 1984 to begin determination of allowable marketing expenses for test year 1986.

68. It is reasonable for AT&T-C to spend modest amounts of its marketing budget to keep its customers informed about rate changes and new service options that may become available from time to time.

69. There is no evidence in the Phase II record that any telecommunications service rendered by AT&T or AT&T-C is poor; if anything, there were numerous comments and/or opinions of good service by AT&T and AT&T-C.

70. Due to the start-up activities that were necessitated by divestiture, AT & T-C's marketing expenses during 1984 were unrepresentatively low for purposes of setting 1986 test year marketing expenses.

71. Even with an adjustment for the level of equal access activity undertaken that year, AT & T-C's marketing expenses during 1985 were unrepresentatively high for purposes of setting 1986 test year marketing expenses.

72. An equitable level of marketing expenses for test year 1986 can be established by averaging AT & T-C's actual marketing

were also used and useful in AT&T-C's California intrastate operations during all or part of 1986.

12. AT&T-C confirmed the taking back of certain intrastate customer billing functions through renegotiation of costs for such services previously performed by Pacific Bell and other LECs and passing through to its California intrastate operations $20.454 million in 1986 expense reductions, by a compliance filing on July 23, 1986 in Phase I of this proceeding.

13. Confusion reigned throughout this proceeding regarding which, if any, of the eight separate functions of AT&T's customer service and billing program were operational for California intrastate operations during 1986, and DRA and AT&T-C were unable to resolve this issue during this proceeding.

14. Account inquiry, service order entry, account maintenance, and message investigation functions of the customer service and billing program were in place and used and useful in California during test year 1986.

15. Message toll service (MTS) billing, MTS message processing, MTS credit and collection, and MTS remittance processing functions of the customer service and billing program will not be in service or used and useful in California until June 1988 or later.

16. The modest $5.7 million expense deferral for its customer service and billing program urged in AT&T-C's closing brief was not supported effectively by a record which demonstrates that the LECs still perform significant amounts of work and incur large expenses for billing and collection functions.

17. The $9.1 million deferral in an interest-bearing memorandum account properly sets a compromise for what DRA reluctantly agrees are used and useful customer service and billing functions performed by AT&T-C in test year 1986 and the need to preclude cost duplication for work concurrently performed by the LECs.

were also used and useful in AT&T-C's California intrastate operations during all or part of 1986.

12. AT&T-C confirmed the taking back of certain intrastate customer billing functions through renegotiation of costs for such services previously performed by Pacific Bell and other LECs and passing through to its California intrastate operations $20.454 million in 1986 expense reductions, by a compliance filing on July 23, 1986 in Phase I of this proceeding.

13. Confusion reigned throughout this proceeding regarding which, if any, of the eight separate functions of AT&T's customer service and billing program were partially or fully operational for California intrastate operations during 1986, and DRA and AT&T-C were unable to resolve this issue during this proceeding.

14. Account inquiry, service order entry, account maintenance, and message investigation functions of the customer service and billing program were deployed to California in 1984 and at least partially used and useful in California during test year 1986 based on AT&T-C's late-filed Exhibit 250.

15. Message toll service (MTS) billing, MTS message processing, MTS credit and collection, and MTS remittance processing functions of the customer service and billing program will not be in service or used and useful in California until June 1988 or later.

16. The modest $5.7 million expense deferral for its customer service and billing program urged in AT&T-C's closing brief was not supported effectively by a record which demonstrates that the LECs still perform significant amounts of work and incur large expenses for billing and collection functions.

17. The $9.1 million deferral in an interest-bearing account (as computed by DRA at the ALJ's request of used and useful customer service and billing functions performed by AT&T-C in test year 1986) sets a compromise between DRA's record position that $20.1 million be disallowed recognizing that only the account

expenses for 1984 and its marketing expenses for 1985 as adjusted by DRA for carrier selection activities; on an intrastate basis adjusted for inflation, the proper value is $51.1 million.

73. AT & T-C's marketing efforts have the potential to improve the satisfaction of its customers directly and the satisfaction of its competitors' customers indirectly through competitive forces in the interexchange market.

74. In D. 87-12-070 on December 22, 1987, the Commission ordered AT & T-C to consolidate a series of subsequent changes in the access charges that AT & T-C pays to local exchange companies into a memorandum account with interest for later reflection in AT & T-C's rates in order to minimize administrative costs and customer confusion due to frequent and potentially offsetting AT & T-C rate changes.

75. The local exchange access charge reductions that were consolidated into the memorandum account occurred as a result of Commission orders in D. 87-12-070 (December 22, 1987), D. 87-12-051 (December 22, 1987), D. 87-12-067 (December 22, 1987), and D. 88-01-061 (January 28, 1988).

76. A balance began to accrue in AT & T-C's memorandum account on January 1, 1988.

77. All interexchange telephone companies purchasing local exchange access have received proportionately similar access charge reductions from local exchange companies regulated by this Commission.

78. As previously discussed, because AT & T-C's competitors have received similar reductions in the access charges they pay, a prospective AT & T-C rate adjustment to reflect these access charge reductions will not competitively disadvantage other interexchange carriers.

79. It is not practicable to refund the balance in AT & T-C's access charge reduction memorandum account based on customer usage dating back more than 90 days from the present due to the

18. I.88-01-007 is the appropriate forum for determining the reasonableness of AT&T-C's plan and costs to directly bill its customers for interstate and interLATA message toll service.

19. Interest accrual on the deferred account at the average three-month commercial paper rate, as published in the Federal Reserve Bulletin, will offset AT&T-C's loss of productive use of its funds expended in developing its customer service and billing system, until the system is fully used and useful in and non-duplicative of other similar services currently used by AT&T-C in California.

20. The remaining intrastate expense level previously adopted on an interim basis for AT&T-C's billing and collection in D.86-11-079, for functions not yet used and useful, after exclusion of the $9.1 million in the amount of $166,981,000 for test year 1986, is reasonable.

21. While AT&T's overall corporate headquarters organization has changed significantly, with substantial headquarters staff reductions in the post-divestiture structure, specific corporate headquarters functions continue to be predominantly investor-related.

22. The overall advertising budget for AT&T-C's test year 1986 was adopted in Phase I of this proceeding and no further consideration of AT&T-C or AT&T-CH advertising issues is necessary or appropriate in this Phase II decision.

23. AT&T-C has advanced arguments worthy of our consideration regarding the need for, and ratepayer benefits of, public relations and employee information functions and activities at and after divestiture and more specifically during the period of interexchange carrier of choice selection by the public.

24. Allowances herein, for corporate and field public relations expenses for public and employee information, education, and awareness are unique to the needs associated with divestiture reorganization and interexchange carrier selection periods.

prohibitive costs that would be incurred in retrieving billing information from the local exchange companies that render customer bills for AT & T-C.

80. Because it is not practicable to base refunds on more than the last 90 days of customer usage, we cannot match refunds to exact customer usage during the period of the memorandum account.

81. The process of granting refunds based on the previous 90 days of customer usage would involve substantial administrative costs as outlined in AT & T-C's response to CACD's data request 88-04-08C; the cost for Pacific Bell would be $1.6 million, while undetermined other costs would be expended by other local exchange companies that bill for AT & T-C.

82. The possibly greater precision of providing refunds to customers based on recent usage within 90 days is not a compelling reason for undertaking such refunds when the alternative is rate reductions based on usage during the next six months.

83. A prospective AT & T-C rate reduction will enable customers to make many more calls in response to lower rates. This benefit is substantial.

84. Had the Commission not ordered AT & T-C to consolidate its access charge reductions into a memorandum account, the alternative would have been a series of AT & T-C rate adjustments occurring after the period that the California Association of Long Distance Companies alleges its members ceased or greatly reduced their use of AT & T-C WATS service.

85. AT & T-C's advice letter 97 proposes two rate adjustments during the next six months.

86. The Commission's objective of minimizing customer confusion and administrative cost would be better met by a single AT & T-C rate adjustment to end the memorandum account and reflect the other rate impacts of this decision.

87. A uniform percentage rate adjustment for switched services will minimize customer confusion and administrative costs.

inquiry function was in place, and AT&T-C's request for full recovery of its development and deployment of a separate customer service and billing system in test year 1986. This deferral also recognizes the need to preclude cost duplication for work concurrently performed by the LECs.

18. I.88-01-007 is the appropriate forum for determining the reasonableness of AT&T-C's plan and costs to directly bill its customers for interstate and interLATA message toll service.

19. Interest accrual on the deferred account at the average three-month commercial paper rate, as published in the Federal Reserve Bulletin, will offset AT&T-C's loss of productive use of its funds expended in developing its customer service and billing system, until the system is fully used and useful in and non-duplicative of other similar services currently used by AT&T-C in California.

20. The remaining intrastate expense level previously adopted on an interim basis for AT&T-C's billing and collection in D.86-11-079, for functions not yet used and useful, after exclusion of the $9.1 million in the amount of $166,981,000 for test year 1986, is reasonable.

21. While AT&T's overall corporate headquarters organization has changed significantly, with substantial headquarters staff reductions in the post-divestiture structure, specific corporate headquarters functions continue to be predominantly investor-related.

22. The overall advertising budget for AT&T-C's test year 1986 was adopted in Phase I of this proceeding and no further consideration of AT&T-C or AT&T-CH advertising issues is necessary or appropriate in this Phase II decision.

23. AT&T-C has advanced arguments worthy of our consideration regarding the need for, and ratepayer benefits of, public relations and employee information functions and activities at and after

divestiture and more specifically during the period of interexchange carrier of choice selection by the public.

24. Allowances herein, for corporate and field public relations expenses for public and employee information, education, and awareness are unique to the needs associated with divestiture reorganization and interexchange carrier selection periods.

25. Public relations expenses for functions including sponsorship of media events and cultural activities, charitable activities, and corporate image enhancement are clearly investor-related functions and it is this Commission's long-standing policy to not burden ratepayers with such costs.

26. DRA auditors' recommended partial disallowances of AT&T-CH expenses for identifiable investor-related legal department and corporate finance and accounting functions, as further described by AT&T-C witness Ankiel, appear reasonable and should be adopted.

27. AT&T-CH's Corporate Strategy and Development functions, as further described by AT&T-C's witness Ankiel, are clearly investor-related and have routinely been disallowed in the past by this Commission. There was no new evidence in this proceeding which would warrant a different treatment of these expenses for AT&T-C in test year 1986.

28. DRA's recommended equal-to-all lines of business allocation method does have merit when allocating the expenses for specific services that are of equal benefit to all affiliated or subsidiary companies.

29. The use of DRA's proposed equal-to-all lines of business allocations method should be developed further in cooperation with other regulatory agencies across the nation, and then presented again as and if appropriate in future AT&T-C general rate proceedings.

30. D.87-12-063 has exempted AT&T-C from the need to reestablish and maintain an Account 674 for affiliate company transactions. However, AT&T-C is required by the same order to maintain its "affiliate company costs on a side record basis." (D.87-12-063, mimeo. p. 48.)

31. D.86-11-079 for Phase I of this proceeding left the record open to receive DRA's audit report, and for AT&T-C to fully develop the record before we decide the issue of which, and what

88. The private line adjustment included in AT&T's Advice Letter 97 is appropriate to reflect costs.

89. To require AT&T-C to report corporate reorganizations or headquarters operational expense changes which would result in changes in expenses to California operations of less than $100,000 would constitute an undue burden, and alternatively to require lesser records of AT&T-C's expenses and allocated costs would deny the Commission staff the opportunity for reasonable reviews of the utility's operations consistent with future auditing requirements.

Conclusions of Law

1. Notwithstanding DRA's lead position for presenting issues, the requirement for a showing of reasonableness for any and all expenses under review in Phase II of A.85-11-029 should rest fully with AT&T-C.

2. AT&T's reorganization, initiated in 1986, should cut costs, improve the efficiency and the competitive position of AT&T's overall operations for the future.

3. DRA's recommended $3.5 million reorganization adjustment should be proportionately reduced to apply to the authorized rather than budgeted marketing expenses for test year. Failure to do so would have the effect of adopting a greater, $5.3 million adjustment, against the marketing budget than the amount identified by DRA.

4. AT&T-C confirmed that account inquiry, service order entry, account maintenance, and message investigation functions of the customer service and billing program were at least partially n place and used and useful in California during test year 1986; therefore, some expenses for these functions should be adopted for the test year.

5. Message toll (telecommunications) service (MTS) billing, MTS message processing, MTS credit and collection, and MTS remittance processing functions of the customer service and billing program were not in service during test year 1986 and will not be

level of AT&T-CH and NOMC allocated public relations expenses are reasonable for ratemaking purposes in test year 1986 for AT&T-C's California intrastate operations.

32. AT&T Communications, Inc. (NOMC) did not maintain its books and accounting records on a basis wherein activities and projects could be specifically identified and accounted for during test year 1986.

33. Because NOMC accounting records were not maintained on a project or activity basis, DRA auditors utilized an alternative to their traditional auditing method, which involved meetings with department representatives of each NOMC department and review of examples of departmental outputs.

34. While dissatisfied with lack of project tracking and record-keeping, DRA did not make disallowances for the finance, legal, and personnel functions of NOMC, or the operator services allocated to NOMC's Network function from AT&T-CH.

35. Public relations functions which were directed at providing timely, accurate, and consistent information to the public at or shortly after divestiture and at the time of interexchange carrier selection were beneficial to AT&T-C's ratepayers.

36. Public relations expenses for functions directed at improvement of employee morale at the time of reorganization after divestiture were beneficial to ratepayers.

37. Divestiture brought about major corporate organizational changes for AT&T, and a one-time allowance to share the public relations functional expenses between investors and ratepayers, during this period of major reorganization, should be given serious consideration.

38. Public relations expenses for activities and functions that primarily improve corporate image and/or benefit AT&T's investors should continue to be disallowed for ratemaking purposes.

raised in Phase II relative to AT&T-C's 1986 advertising budget; therefore, the reasonableness of advertising expenses should not be an issue for consideration in Phase II of A.85-11-029.

23. AT & T-C's intrastate marketing allowance of $44.7 million should be revised to $51.1 million consistent with the preceeding discussion and findings of fact.

24. Any future allocation of marketing expenses to AT&T-C's California operations should be performed by direct assignment based on need and benefit rather than on a percentage of revenue basis as used for this proceeding.

25. Neither Public Utilities Code 453.5 nor <u>California Manufacturer's Association v. Public Utilities Commission</u> (1979) 24 Cal. 3d 836 nor <u>Cory v. Public Utilities Commission</u> (1983) 33 Cal. 3d 522, prevent the Commission from ordering AT & T-C to reflect the balance of its access charge memorandum account in a prospective rate adjustment.

26. AT & T-C should be ordered to reduce its rates to reflect the balance of its access charge memorandum account and the other rate impacts of this decision.

27. AT & T-C's Advice Letter 97 should be rejected in favor of a uniform switched services rate adjustment and six-month surcredit to be effective July 1, 1988.

28. AT & T-C's private line rate adjustment in Advice Letter 97 should be approved.

39. Access charges are collected by AT&T Communications companies in message toll rates and then are passed on to the LECs. Therefore, there is no more logic to including access charges in revenues and expenses for allocation purposes than to include taxes in these factors.

40. The elimination of one of the three factors entirely because it (revenue factor) improperly included access charges, and failure to replace it with a more reasonable factor, causes an improper allocation result.

41. The 1985 usage factor is comparable to the 1986 revenue factor and was used as a proxy for the revenue factor excluding access charges in this decision.

42. The fact that AT&T had retained nearly 89% of the 1983 gain on sale of its 195 Broadway building and land was first discovered during DRA's 1986 audit of AT&T's operations.

43. American in 1983 passed on to the then Bell System Operating Companies $10.4 million, representing approximately 11% of the after taxes gain on the July 1, 1983 sale of its 195 Broadway headquarters building, including interest. The balance of the gain and interest was then remitted to the AT&T Foundation, a charitable trust.

44. Neither AT&T-C's 50% nor DRA's 100% suggested pass-through of the remaining gain on sale is reasonable, based on their widely diverse simplistic review of license contract allowances by this Commission over the years.

45. An adjustment of $2,000,000 equal to about 75% of the amount of gain computed by DRA to be allocated to AT&T-C's California intrastate operations reasonably and adequately represents the ratepayer contributions to PT&T's license contract payments from 1918 through 1983.

46. A memorandum account adjustment to rate base will assure that any resulting revenue reduction will be prospective only and will not affect prior earnings of AT&T-C.

39. Access charges are collected by AT&T Communications companies in message toll rates and then are passed on to the LECs. Therefore, there is no more logic to including access charges in revenues and expenses for allocation purposes than to include taxes in these factors.

40. The elimination of one of the three factors entirely because it (revenue factor) improperly included access charges, and failure to replace it with a more reasonable factor, causes an improper allocation result.

41. The 1985 usage factor is comparable to the 1986 revenue factor and was used as a preferable substitute for the revenue factor excluding access charges in this decision.

41a. The usage factor more accurately allocates costs based on use activity in any given AT&T Communications subsidiary IEC, since usage is independent of rates which are set at different levels by each regulatory agency.

41b. In applying the 1985 switched usage factor, private line usage impact was inadvertently excluded, therefore it is necessary to include the private line revenues of 9.2% as suggested by AT&T-C to further adjust (increase) NOMC allocated expenses to AT&T-C's California intrastate operations by $100,000 rounded. However, this finding should not be construed to mean that we have in any way softened on our position that revenues are not an appropriate factor for allocations of out-of-state expenses.

42. The fact that AT&T had retained nearly 89% of the 1983 gain on sale of its 195 Broadway building and land was first discovered during DRA's 1986 audit of AT&T's operations.

43. American in 1983 passed on to the then Bell System Operating Companies $10.4 million, representing approximately 11% of the after taxes gain on the July 1, 1983 sale of its 195 Broadway headquarters building, including interest. The balance of the gain and interest was then remitted to the AT&T Foundation, a charitable trust.

ORDER

IT IS ORDERED that:

1. AT&T Communications of California, Inc.'s (AT&T-C) test year intrastate revenue requirement is reduced by $4.4 million effective January 1, 1987, from the level adopted on an interim basis in D.86-11-079, consistent with the preceding discussion and the adjustments adopted in this decision.

2. AT & T-C Advice Letter 97 is rejected.

3. Within ten days of the effective date of this order AT & T-C shall file an advice letter with revised tariff sheets to reflect a uniform percentage adjustment of its rates and surcharges for switched services consistent with the discussion, findings and conclusions of this decision. The balance in the access charge reduction memorandum account shall be amortized on a uniform basis from July 1, 1988 through December 31, 1988. AT & T-C shall adjust its rates and or surcharges for non-switched services and for the impact of D.88-01-061 consistent with the treatment proposed in Advice Letter 97. The effective date of the ordered revisions shall be July 1, 1988.

4. Consistent with ordering paragraph 4 in D. 87-10-088, AT & T-C shall file a separate advice letter with revised tariff sheets within ten days of this order to pass through on a uniform basis from July 1, 1988 to December 31, 1988 the balance remaining in the memorandum account associated with that decision. For administrative convenience, AT & T-C shall consolidate the rate changes in ordering paragraph b with this change to produce a set of consolidated tariff sheets.

5. AT&T-C shall include with the Commission's copies of the advice letter filing, supporting workpapers setting forth the calculations for each of the rate changes and resulting rate reduction components and the overall rate reduction. CACD shall verify the proper rate and surcharge changes.

47. Any requirement for a future allocation of this adjustment for gain on sale of the 195 Broadway building to Pacific Bell for it, or its predecessor PT&T, as suggested by AT&T-C, is clearly inappropriate since neither of these entities ever obtained productive receipt of any portion of nearly 89% of the remaining gain on this transaction.

48. The Western Electric adjustment for the predivestiture assets of PT&T which were segregated to AT&T-C should be amortized over an 11-year period to moderate the impact of this adjustment on AT&T-C's earnings and spread this ratepayer benefit over 11 years.

49. The 11-year amortization of the Western Electric adjustment on AT&T-C's assets received from PT&T on January 1, 1984 will result in a net revenue reduction of $738,000 and a .20% reduction on the rate of return for AT&T-C's intrastate operations.

50. AT&T-C's reporting of its annual construction budget, its purchases from Technologies which are expensed and capitalized, and the capital structure of Technologies will assist DRA in determining whether such transactions are significant enough to warrant further review of Technologies earnings in the future.

51. Reasonable detail in the record-keeping by Technologies will assist in future DRA review of the reasonableness of Technologies' transactions with AT&T-C.

52. The work performed by American Transtech in servicing securities and providing other investor-related services for AT&T, on an affiliated basis, is not as risky as AT&T's manufacturing or telephone utility operations.

53. AT&T-C has not presented persuasive evidence to show that the services it receives from American Transtech should be priced to derive a greater rate of return than that authorized for its telephone operations.

54. While American Transtech has reduced its charges to AT&T for services rendered in 1986, the adopted test year estimates in AT&T-C's last general rate decision, D.86-11-079, were based on the

44. Neither AT&T-C's 50% nor DRA's 100% suggested pass-through of the remaining gain on sale is reasonable, based on their widely diverse simplistic review of license contract allowances by this Commission over the years.

45. An adjustment of $2,000,000 equal to about 75% of the amount of gain computed by DRA to be allocated to AT&T-C's California intrastate operations reasonably and adequately represents the ratepayer contributions to PT&T's license contract payments from 1918 through 1983.

46. A memorandum account adjustment to rate base will assure that any resulting revenue reduction will be prospective only and will not affect prior earnings of AT&T-C.

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50. AT&T-C's reporting of its annual construction budget, its purchases from Technologies which are expensed and capitalized, and the capital structure of Technologies will assist DRA in determining whether such transactions are significant enough to warrant further review of Technologies earnings in the future.

6. Since this order resolves all 1986 test year issues held open in Ordering Paragraphs 2, 15, and 18 of D.86-11-079, this matter is closed.

7. AT&T-C shall file copies of the reports, as set forth in Appendix D, to the addressees specified. This reporting requirement [except for those reports required by General Order 104 and the monthly earnings reports provided pursuant to Ordering Paragraph 8 of D.85-03-056 and General Order 65-A, and the record retention requirements of General Order 28-A] shall terminate upon submission of the reports for calendar year 1992, to be filed on or before March 31, 1993, unless earlier modified, extended, or discontinued by further order of this Commission. Should the Commission grant pricing flexibility to AT&T-C in its A.87-10-039, modifications to these requirements may be appropriate earlier. Parties are directed to discuss the appropriate nature of such modifications in A.87-10-039.

This order is effective today.

Dated ____________________, at San Francisco, California.

expense estimates for calendar year 1985 and therefore still require adjustment from the prereduction level.

55. DRA's recommended audit adjustment of $100,000 annually to the charges incurred by AT&T-C on its intrastate operations for the investor-related and other services provided by American Transtech is reasonable.

56. The 50% predivestiture adjustment of Bell Labs' expenses because of its 50% ownership by Western Electric is no longer appropriate, since Technologies, the successor to Western Electric, has no ownership control of Bell Labs.

57. In Phase I of this proceeding TURN raised serious concerns whether the results of R&D effort would be used and useful to AT&T-C's customers in the near future. These concerns were not adequately addressed in the evidence submitted in Phase II.

58. Neither DRA nor AT&T-C provided evidence to show that Technologies will not receive a disproportionately greater benefit from Bell Labs' R&D efforts than will AT&T's telecommunications utilities.

59. While the risks associated with failing R&D projects were discussed with reasonable accuracy on the record, the real business risk of Bell Labs, whose AT&T funding is based on contributions from affiliated companies, was not addressed in a well-defined or comprehensive manner.

60. From the overall record before us, it appears that AT&T-C's own business risk as a provider of interLATA and interstate telecommunications is greater, due to a modest amount of competition from other interexchange carriers, than that of Bell Labs on R&D performed for AT&T's communications companies.

61. It is reasonable to require AT&T-C to demonstrate on a program-by-program basis the potential near term benefits to its California customers of Bell Labs' R&D activities in future rate proceedings, prior to adopting such expenses for any new test period.

51. Reasonable detail in the record-keeping by Technologies will assist in future DRA review of the reasonableness of Technologies' transactions with AT&T-C.

52. The work performed by American Transtech in servicing securities and providing other investor-related services for AT&T, on an affiliated basis, is not as risky as AT&T's manufacturing or telephone utility operations.

53. AT&T-C has not presented persuasive evidence to show that the services it receives from American Transtech should be priced to derive a greater rate of return than that authorized for its telephone operations.

54. While American Transtech has reduced its charges to AT&T for services rendered in 1986, the adopted test year estimates in AT&T-C's last general rate decision, D.86-11-079, were based on the expense estimates for calendar year 1985 and therefore still require adjustment from the prereduction level.

55. DRA's recommended audit adjustment of $100,000 annually to the charges incurred by AT&T-C on its intrastate operations for the investor-related and other services provided by American Transtech is reasonable.

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58. Neither DRA nor AT&T-C provided evidence to show that Technologies will not receive a disproportionately greater benefit from Bell Labs' R&D efforts than will AT&T's telecommunications utilities.

62. The concerns raised by TURN in Phase I of this proceeding relative to the near term usefulness of Bell Labs' ongoing R&D efforts were not resolved by the evidence presented in Phase II of this proceeding.

63. The $300,000 adjustment in the allocated intrastate expenses to AT&T-C for Bell Labs' R&D efforts is the minimum reasonable disallowance for such expenses and only serves to bring rate of return parity to Bell Labs with that of AT&T-C.

64. D.86-11-079 authorized a combined advertising and marketing budget of $126,623,000 of which $22,393,000 was allocated to advertising and $104,230,000 to marketing functions for test year 1986.

65. The combined advertising and marketing allowance of $126,623,000 represents $8.90 for each of the state's total estimated 14.2 million access lines, and this should be compared with the last authorized advertising and marketing allowance of $67.5 million which amounted to $5 for each of the estimated 13.5 million access lines in California for test year 1984.

66. D.86-11-079 adopted the amount of $22,393,000 for test year advertising functions, and no further issues were raised in Phase II relative to AT&T-C's test year 1986 advertising budget.

67. D.87-04-041 granted limited rehearing on the marketing issue to allow AT&T-C to present argument as to whether 1985 was more appropriate than 1984 to begin determination of allowable marketing expenses for test year 1986.

68. It is reasonable for AT&T-C to spend modest amounts of its marketing budget to keep its customers informed about rate changes and new service options that may become available from time to time.

69. There is no evidence in the Phase II record that any telecommunications service rendered by AT&T or AT&T-C is poor; if anything, there were numerous comments and/or opinions of good service by AT&T and AT&T-C.

59. While the risks associated with failing R&D projects were discussed with reasonable accuracy on the record, the real business risk of Bell Labs, whose AT&T funding is based on contributions from affiliated companies, was not addressed in a well-defined or comprehensive manner.

60. From the overall record before us, it appears that AT&T-C's own business risk as a provider of interLATA and interstate telecommunications is greater, due to a modest amount of competition from other interexchange carriers, than that of Bell Labs on R&D performed for AT&T's communications companies.

61. It is reasonable to require AT&T-C to demonstrate on a program-by-program basis the potential near term benefits to its California customers of Bell Labs'. R&D activities in future rate proceedings, prior to adopting such expenses for any new test period.

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70. Little marketing effort and funds are devoted to the smaller residential and business customers of AT&T-C who represent over 65% of its message toll customer accounts.

71. Once carrier selection is made (by an average or small customer) and the customer is not moving or dissatisfied, AT&T-C does not believe it is necessary to provide information to such customer regarding carrier reselection.

72. It is apparent from the record in this proceeding that AT&T-C is directing the majority of its marketing activities and budget to the retention of its larger business and industrial accounts, and to attract back some of the business that has been lost to competing interexchange carriers.

73. Absent a cost-benefit study demonstrating benefits over costs of marketing to the majority of AT&T-C's customers, it appears unreasonable for AT&T-C to use the bulk of its marketing funds, provided by a broad base of small, medium, and large toll telephone customers, to retain or expand AT&T-C's base of large commercial and industrial toll users in the face of mandated competition.

74. Witness Therrien on behalf of TURN correctly pointed out that AT&T-C failed, both in Phase I and Phase II of this proceeding, to provide evidence or a cost-effectiveness study to demonstrate that any part of its spending for marketing during test year 1986 was cost-justified or reasonable, and that AT&T did not and could not distinguish costs for servicing existing customers from those of marketing for new customers.

75. From the widely divergent views of the parties in Phase II of this proceeding, especially concerning the increased cost expanded marketing efforts undertaken in preparation for equal access in 1985, and the reorganizations of AT&T for improved efficiency and reductions of future costs, it would be difficult to conclude that 1985 (as booked) was a more representative base year

66. D.86-11-079 adopted the amount of $22,393,000 for test year advertising functions, and no further issues were raised in Phase II relative to AT&T-C's test year 1986 advertising budget.

67. D.87-04-041 granted limited rehearing on the marketing issue to allow AT&T-C to present argument as to whether 1985 was more appropriate than 1984 to begin determination of allowable marketing expenses for test year 1986.

68. It is reasonable for AT&T-C to spend modest amounts of its marketing budget to keep its customers informed about rate changes and new service options that may become available from time to time.

69. There is no evidence in the Phase II record that any telecommunications service rendered by AT&T or AT&T-C is poor; if anything, there were numerous comments and/or opinions of good service by AT&T and AT&T-C.

70. Following initial carrier of choice selection little marketing effort and funds are devoted to the smaller residential and business customers of AT&T-C who represent over 65% of its message toll customer accounts.

71. Once carrier selection is made (by an average or small customer) and the customer is not moving or dissatisfied, AT&T-C does not believe it is necessary to provide information to such customer regarding carrier reselection.

72. It is apparent from the record in this proceeding that, after initial carrier selection was completed, AT&T-C began directing the majority of its marketing activities and budget to the retention of its larger business and industrial accounts, and to attract back some of the business that has been lost to competing interexchange carriers.

73. Absent a cost-benefit study demonstrating benefits over costs of marketing to the majority of AT&T-C's customers, it appears unreasonable for AT&T-C to seek an even greater marketing allowance and use the bulk of these marketing funds, provided by a

for establishing marketing levels for future years than the 1984 base period heretofore adopted.

76. Based on a balanced review of the overall record in this Phase II proceeding, we have again determined that the $104,230,000 allowance for AT&T-C's test year 1986 marketing activities on a total California basis ($44.7 million on an intrastate basis) is an adequate amount of overall marketing expenses as we had previously determined and found reasonable in D.86-11-079.

77. AT&T-C should be directed to produce better justification in its next proceeding, that its marketing expenditures provide a proven cost benefit to its small, average, and large use customers.

Conclusions of Law

1. Notwithstanding DRA's lead position for presenting issues, the requirement for a showing of reasonableness for any and all expenses under review in Phase II of A.85-11-029 should rest fully with AT&T-C.

2. AT&T's reorganization, initiated in 1986, should cut costs, improve the efficiency and the competitive position of AT&T's overall operations for the future.

3. DRA's recommended $3.5 million reorganization adjustment should be proportionately reduced to apply to the authorized rather than budgeted marketing expenses for test year. Failure to do so would have the effect of adopting a greater, $5.3 million adjustment, against the marketing budget than the amount identified by DRA.

4. AT&T-C confirmed that account inquiry, service order entry, account maintenance, and message investigation functions of the customer service and billing program were in place and used and useful in California during test year 1986; therefore, the expenses for these functions should be adopted for the test year.

5. Message toll (telecommunications) service (MTS) billing, MTS message processing, MTS credit and collection, and MTS remittance processing functions of the customer service and billing

broad base of small, medium, and large toll telephone customers, to retain or expand AT&T-C's base of large commercial and industrial toll users in the face of mandated competition.

74. Witness Therrien on behalf of TURN correctly pointed out that AT&T-C failed, both in Phase I and Phase II of this proceeding, to provide evidence or a cost-effectiveness study to demonstrate that any part of its spending for marketing during test year 1986 was cost-justified or reasonable, and that AT&T did not and could not distinguish costs for servicing existing customers from those of marketing for new customers.

75. From the widely divergent views of the parties in Phase II of this proceeding, especially concerning the increased cost expanded marketing efforts undertaken in preparation for equal access in 1985, and the reorganizations of AT&T for improved efficiency and reductions of future costs, it would be difficult to conclude that 1985 (as booked) was a more representative base year for establishing marketing levels for test year 1986 and future years than the 1984 base period heretofore adopted.

76. Based on a balanced review of the overall record in this Phase II proceeding, we have again determined that the $104,230,000 allowance for AT&T-C's test year 1986 marketing activities on a total California basis ($44.7 million on an intrastate basis) is an adequate amount of overall marketing expenses as we had previously determined and found reasonable in D.86-11-079.

77. AT&T-C should be directed to produce better justification in its next proceeding, that its marketing expenditures provide a proven cost benefit to its small, average, and large use customers.

78. As of July 1, 1988 AT&T will have overcollected and retained in various accounts heretofore prescribed $118.5 million in excess of its currently authorized cost of service adopted herein.

program were not in service during test year 1986 and will not be in service or used and useful until June 1988 or later; therefore, any and all expenses associated with the development of these functions should be excluded from AT&T-C's test year results of operations.

6. The DRA's recommended test year 1986 California intrastate disallowance of approximately $20.1 million and deferral of all expenses associated with the development and deployment of AT&T's customer service and billing program, excepting for account inquiry functions, is insupportable based on the record, which demonstrated that certain other program functions were also used and useful in AT&T-C's California intrastate operations during all or part of 1986; therefore, DRA's recommendation should not be adopted.

7. The modest $5.7 million intrastate expense deferral for its customer service and billing program urged in AT&T-C's closing brief should not be adopted because it was not supported by a record which demonstrates that the LECs still perform significant amounts of work and incur large expenses for billing and collection functions.

8. A $9.1 million intrastate expense deferral in an interest-bearing memorandum account should be adopted since it represents a reasonable recognition of what DRA reluctantly agrees are used and useful customer service and billing functions performed by AT&T-C in test year 1986, and given the need to preclude cost duplication to AT&T-C's customers for work concurrently performed by the LECs during and well beyond the test year.

9. The overall advertising budget for AT&T-C's test year 1986 operations was adopted in Phase I of this proceeding by D.86-11-079, and further consideration of AT&T-C or AT&T-CH advertising issues is beyond the scope of the limited rehearing granted in D.87-04-041.

79. Further accrual of overcollections may be terminated by setting rates for AT&T-C's California intrastate operations on a current cost of service basis as adopted herein.

80. Deterioration of value of the overcollected amount can be mitigated by requiring that these funds be placed into an interest bearing memorandum account to accrue interest at the average three-month commercial paper rate to the date refunds are made.

81. While the Commission does have the authority to reduce rates prospectively, to refund overcollections pursuant to PU Code § 453.5, it is preferable when practicable to refund the overpayments by a one-time credit based on prior usage, and thus maintain prospective rates on a current cost of service basis.

82. To require AT&T-C to research customer usage records from March 1986 to the present to implement a refund plan and thus expend an estimated three million man-hours and $90 million doing so, is unreasonable and impractical.

83. Recorded customer usage data for the past three months is maintained by the LECs and is available as a basis for making retrospective refunds based on prior intrastate interLATA usage for AT&T-C's current customers and the costs associated with this effort and estimated to be modest in relation to the amount being refunded.

84. It is reasonable to require IECs, large business customers and all customers who may have used little or no intrastate service from AT&T-C during the period of April 1, through June 30, 1988 to develop their own claims for refunds, with appropriate calculations together with supporting bills, and present this documentation to AT&T-C for possible refunds of overcollections during the period from March 1986 through June 30, 1988.

85. Absent the receipt of a proper claim for refunds of any prior overcollections, it is reasonable to only require that AT&T-C issue a refund or credit for all prior overcollections based on

10. Sharing the cost of public relations expenses between investors and ratepayers for providing timely, accurate, and consistent information to ratepayers and the general public, regarding changes in available services and to employees regarding changes in corporate functions, direction and reorganization, on a one-time basis after divestiture, is reasonable and should be adopted to the extent specified in this decision.

11. DRA's use of an alternative to its traditional auditing method, involving meetings with departmental representatives of each NOMC department and then reviewing examples of each department's outputs should be accepted as reasonable in view of the lack of availability of accounting records for specific NOMC activities and functions.

12. Access charges, which are collected from ratepayers by AT&T-C and then passed on to the LECs, like taxes, should be excluded from allocation factors used for allocating general services and home office expenses.

13. Direct assignment of general services and home office expenses wherever possible, on a specific project basis, is preferable to any allocation method using representative factors and should be adopted instead of functional allocations in future rate proceedings.

14. American in 1983 passed on to the then Bell System Operating Companies $10.4 million, representing approximately 11% of the after taxes gain on the July 1, 1983 sale of its 195 Broadway headquarters building, including interest; AT&T-C should be required to pass through to its California ratepayers the properly allocated amount of the remaining 89% of the gain on sale of the 195 Broadway headquarters building based on contributions made by these ratepayers through the predivestiture license contract between PT&T and American.

15. A requirement for Pacific Bell or its predecessor PT&T to bear any additional pass-through expense of the AT&T remaining

data related to the intrastate service usage of its customers during the period of April 1 through June 30, 1988.

86. AT&T-C's Advice Letter 97 proposing two major rate adjustments over the next six months to offset prior overcollections through prospective use is not reasonable or equitable, especially for customers who have reduced their usage of AT&T-C's intrastate services or have terminated such services.

87. It is not unreasonable to ask AT&T-C customers who believe that they are entitled to a different refund amount than the standard three-month method provides, to submit their basis for such claims, the calculations thereof, and the supporting bills therefor.

88. It is reasonable for AT&T-C to deny claims for refunds submitted to it without proper support and may instead provide a standard refund credit in such cases, where applicable.

89. To require AT&T-C to report corporate reorganizations or headquarters operational expense changes which would result in changes in expenses to California operations of less than $100,000 would constitute an undue burden, and alternatively to require lesser records of AT&T-C's expenses and allocated costs would deny the Commission staff the opportunity for reasonable reviews of the utility's operations consistent with future auditing requirements.

<u>Conclusions of Law</u>

1. Notwithstanding DRA's lead position for presenting issues, the requirement for a showing of reasonableness for any and all expenses under review in Phase II of A.85-11-029 should rest fully with AT&T-C.

2. AT&T's reorganization, initiated in 1986, should cut costs, improve the efficiency and the competitive position of AT&T's overall operations for the future.

3. DRA's recommended $3.5 million reorganization adjustment should be proportionately reduced to apply to the authorized rather than budgeted marketing expenses for test year. Failure to do so

(89%) gain on sale of the 195 Broadway building, as AT&T-C suggests in its brief, would be unreasonable and should not be adopted herein, since neither of these entities ever received any portion of the (89%) remaining gain on this transaction.

16. The 11-year amortization of the Western Electric adjustment on the assets segregated to AT&T-C from PT&T at divestiture (January 1, 1984) adopted herein represents a reasonable compromise between the interests of AT&T-C's customers and investors, and spreads this adjustment over the remaining useful life of the property involved.

17. No excessive profit has been demonstrated on AT&T-C's purchases from Technologies during the period of January 1, 1984 through the end of 1986, and no affiliated transaction adjustment should be made on these purchases.

18. Limited reporting with some supplemental record-keeping on (post-1986) and future transactions between Technologies and AT&T-C, as heretofore discussed, is reasonable and should be adopted.

19. The investor-related and other services provided by American Transtech to AT&T should be adjusted to provide a return on investment no greater than that authorized for AT&T-C's utility operations.

20. The real business risk associated with the current work Bell Labs performs for AT&T's telecommunications companies has not been shown to be greater than that of the telecommunications utilities themselves; therefore, no greater rate of return should be adopted for Bell Labs than that authorized for AT&T-C.

21. The $300,000 adjustment to AT&T-C's 1986 test year intrastate expenses to bring parity to the return on investment of Bell Labs with that of AT&T-C is the minimum reasonable adjustment which could and should be made in this proceeding.

22. D.86-11-079 authorized an advertising expense allowance of $22,393,000 for test year 1986, and no further issues were

would have the effect of adopting a greater, $5.3 million adjustment, against the marketing budget than the amount identified by DRA.

4. AT&T-C confirmed that account inquiry, service order entry, account maintenance, and message investigation functions of the customer service and billing program were at least partially in place and used and useful in California during test year 1986; therefore, some expenses for these functions should be adopted for the test year.

5. Message toll (telecommunications) service (MTS) billing, MTS message processing, MTS credit and collection, and MTS remittance processing functions of the customer service and billing program were not in service during test year 1986 and will not be in service or used and useful until June 1988 or later; therefore, any and all expenses associated with the development of these functions should be excluded from AT&T-C's test year results of operations.

6. The DRA's recommended test year 1986 California intrastate disallowance of approximately $20.1 million and deferral of all expenses associated with the development and deployment of AT&T's customer service and billing program, excepting for account inquiry functions, is insupportable based on the record, which demonstrated that certain other program functions were also used and useful in AT&T-C's California intrastate operations during all or part of 1986; therefore, DRA's recommendation should not be adopted.

7. The modest $5.7 million intrastate expense deferral for its customer service and billing program urged in AT&T-C's closing brief should not be adopted because it was not supported by a record which demonstrates that the LECs still perform significant amounts of work and incur large expenses for billing and collection functions.

raised in Phase II relative to AT&T-C's 1986 advertising budget; therefore, the reasonableness of advertising expenses should not be an issue for consideration in Phase II of A.85-11-029.

23. Once interexchange telecommunications carrier selection is made by an average or small customer and the customer is not moving or dissatisfied with service, AT&T-C does not and should not spend monies to provide further information about carrier reselection to that customer.

24. Given the widely divergent positions of the parties in this proceeding, relative to the expanded marketing effort undertaken by AT&T in 1985 in preparation for equal access balloting, which drove up AT&T's marketing costs in 1985, and its subsequent reorganizations which were intended to improve efficiency and reduce future costs, we should conclude that 1985 was not a representative base year and should not be adopted as a base for establishing reasonable marketing expenses for test year 1986.

25. AT&T-C's combined advertising and marketing allowance of $126,623,000 represents $8.90 for each of the state's total estimated 14.2 million access lines for test year 1986. This previously adopted amount should be reasonable and more than adequate, when compared to the $67.5 million which equated to $5 for each of the estimated 13.5 million access lines in California found reasonable for test year 1984.

26. AT&T-C should be required to produce better justification, in its next rate proceeding or rate investigation, that its "as allocated" marketing expenditures provide a proven cost benefit to its small, average, and large use customers, if it wants its customers to share such expenses.

27. Any future allocation of marketing expenses to AT&T-C's California operations should be performed by direct assignment based on need and benefit rather than on a percentage of revenue basis as used for this proceeding.

8. A $9.1 million intrastate expense deferral in an interest-bearing memorandum account, as computed by DRA at the ALJ's request, should be adopted since it represents a reasonable recognition of some used and useful customer service and billing functions performed by AT&T-C in test year 1986, and the need to preclude cost duplication to AT&T-C's customers for work concurrently performed by the LECs during and well beyond the test year.

9. The overall advertising budget for AT&T-C's test year 1986 operations was adopted in Phase I of this proceeding by D.86-11-079, and further consideration of AT&T-C or AT&T-CH advertising issues is beyond the scope of the limited rehearing granted in D.87-04-041.

10. Sharing the cost of public relations expenses between investors and ratepayers for providing timely, accurate, and consistent information to ratepayers and the general public, regarding changes in available services and to employees regarding changes in corporate functions, direction and reorganization, on a one-time basis after divestiture, is reasonable and should be adopted to the extent specified in this decision.

11. DRA's use of an alternative to its traditional auditing method, involving meetings with departmental representatives of each NOMC department and then reviewing examples of each department's outputs should be accepted as reasonable in view of the lack of availability of accounting records for specific NOMC activities and functions.

12. Access charges, which are collected from ratepayers by AT&T-C and then passed on to the LECs, like taxes, should be excluded from allocation factors used for allocating general services and home office expenses.

13. Direct assignment of general services and home office expenses wherever possible, on a specific project basis, is preferable to any allocation method using representative factors

ORDER

IT IS ORDERED that:

1. AT&T Communications of California, Inc.'s (AT&T-C) test year intrastate revenue requirement is reduced by $10.5 million effective January 1, 1987, from the level adopted on an interim basis in D.86-11-079, consistent with the preceding discussion and the adjustments adopted in this decision.

2. Within 20 days after the effective date of this order, AT&T-C shall file an advice letter in compliance with General Order 96-A, to eliminate the remainder of its existing surcharge, first authorized by Ordering Paragraph 20 of D.86-11-079, and adjust its long distance (including coin sent), 800, WATS and private line service to produce an overall annual revenue reduction, after uncollectibles, of $10.5 million on its California intrastate operations effective for service rendered on and after July 1, 1988, consistent with Ordering Paragraph 1 above.

3. Within 20 days after the effective date of this order, AT&T-C shall file an advice letter in compliance with General Order 96-A, setting forth its refund plan in accordance with the provisions of PU Code Section 453.5, for flowing through to its customers on or before July 1, 1988 the access charge and other reductions in expenses it received, or will receive, as a result of the following decisions:

o	D.87-12-067	Pacific Bell	O.P. 35 & 38
o	D.87-12-070	GTE California	O.P. 1 & 2
o	D.87-12-051	Pacific Bell	O.P. 3
o	D.87-10-088	ULTS (Tracking)	O.P. 2
o	D.88-01-061	Tax Reduction Act	O.P. 1A

[These decisions will result in available refunds of approximately $100 million as of July 1, 1988.] AT&T-C shall also and should be adopted instead of functional allocations in future rate proceedings.

14. American in 1983 passed on to the then Bell System Operating Companies $10.4 million, representing approximately 11% of the after taxes gain on the July 1, 1983 sale of its 195 Broadway headquarters building, including interest; AT&T-C should be required to pass through to its California ratepayers the properly allocated amount of the remaining 89% of the gain on sale of the 195 Broadway headquarters building based on contributions made by these ratepayers through the predivestiture license contract between PT&T and American.

15. A requirement for Pacific Bell or its predecessor PT&T to bear any additional pass-through expense of the AT&T remaining (89%) gain on sale of the 195 Broadway building, as AT&T-C suggests in its brief, would be unreasonable and should not be adopted herein, since neither of these entities ever received any portion of the (89%) remaining gain on this transaction.

16. The 11-year amortization of the Western Electric adjustment on the assets segregated to AT&T-C from PT&T at divestiture (January 1, 1984) adopted herein represents a reasonable compromise between the interests of AT&T-C's customers and investors, and spreads this adjustment over the remaining useful life of the property involved.

17. No excessive profit has been demonstrated on AT&T-C's purchases from Technologies during the period of January 1, 1984 through the end of 1986, and no affiliated transaction adjustment should be made on these purchases.

18. Limited reporting with some supplemental record-keeping on (post-1986) and future transactions between Technologies and AT&T-C, as heretofore discussed, is reasonable and should be adopted.

19. The investor-related and other services provided by American Transtech to AT&T should be adjusted to provide a return

include in this refund plan the amount held subject to refund, due to the reduced revenue requirement adopted in this decision, computed from January 1, 1987 to the date of the refund pursuant to Ordering Paragraph 18 of D.86-11-079 [estimated to be $15.8 million at July 1, 1988]. In addition, AT&T-C shall also include in this refund plan other identifiable amounts which become available for refund by July 1, 1988.

> Interested parties are asked, during the comment period for review of the ALJ's proposed decision, to specifically address their comments or concerns regarding the provisions of Ordering Paragraphs 2 and 3 above and whether these directives fulfill the requirements of PU Code § 453.5. Specifically, in Kenneth Cory v Public Utilities Commission et al. (1983) 33 C 3rd 527, the California Supreme Court, citing its earlier opinion in California Mfrs. Assn. v Public Utilities Com. (1979) 24 Cal. 3d 836, stated:
>
> > "Where the section applies, '"refunds" which are ordered "distributed" by the commission must be allocated according to the statutory formula; present customers (except for small residential users) must be compensated on the basis of their prior usage to which the refund corresponds, and, where practical, prior customers must also participate to the extent of the overcharges which they previously paid.' [Citation omitted.] The court reasoned that refunds of rebates are ordered by the commission 'to be "distributed" whenever it directs their final disposition, thereby dividing and apportioning them.' [Citation omitted.] We also noted that the 'general feasibility of reimbursing many [present and prior] customers in strict accordance with their actual overpayments is demonstrated by past refund plans.'" [Citation omitted.]

4. AT&T-C shall include with the Commission's copies of the advice letter filings, described in Ordering Paragraphs 2 and 3 above, supporting workpapers setting forth the calculations for

on investment no greater than that authorized for AT&T-C's utility operations.

20. The real business risk associated with the current work Bell Labs performs for AT&T's telecommunications companies has not been shown to be greater than that of the telecommunications utilities themselves; therefore, no greater rate of return should be adopted for Bell Labs than that authorized for AT&T-C.

21. The $300,000 adjustment to AT&T-C's 1986 test year intrastate expenses to bring parity to the return on investment of Bell Labs with that of AT&T-C is the minimum reasonable adjustment which could and should be made in this proceeding.

22. D.86-11-079 authorized an advertising expense allowance of $22,393,000 for test year 1986, and no further issues were raised in Phase II relative to AT&T-C's 1986 advertising budget; therefore, the reasonableness of advertising expenses should not be an issue for consideration in Phase II of A.85-11-029.

23. Once interexchange telecommunications carrier selection is made by an average or small customer and the customer is not moving or dissatisfied with service, AT&T-C does not and should not spend monies to provide further information about carrier reselection to that customer.

24. Given the widely divergent positions of the parties in this proceeding, relative to the expanded marketing effort undertaken by AT&T in 1985 in preparation for equal access balloting, which drove up AT&T's marketing costs in 1985, and its subsequent reorganizations which were intended to improve efficiency and reduce future costs, we should conclude that 1985 was not a representative base year and should not be adopted as a base for establishing reasonable marketing expenses for test year 1986.

25. AT&T-C's combined advertising and marketing allowance of $126,623,000 represents $8.90 for each of the state's total estimated 14.2 million access lines for test year 1986. This

each of the rate changes and resulting rate reduction components and the overall rate reduction, as well as for the development of the amount to be refunded on July 1, 1988.

5. In addition to the requirement specified in Ordering Paragraph 3 of D.86-11-079, AT&T-C shall, in future rate proceedings, develop a cost/benefit justification showing that its marketing expenditures provide a proven cost/benefit to its small, medium, or large use customers.

6. Since this order resolves all 1986 test year issues held open in Ordering Paragraphs 2, 15, and 18 of D.86-11-079, this matter is closed.

7. AT&T-C shall file copies of the reports, as set forth in Appendix D, to the addressees specified. This reporting requirement [except for those reports required by General Order 104 and the monthly earnings reports provided pursuant to Ordering Paragraph 8 of D.85-03-056 and General Order 65-A, and the record retention requirements of General Order 28-A] shall terminate upon submission of the reports for calendar year 1992, to be filed on or before March 31, 1993, unless earlier modified, extended, or discontinued by further order of this Commission.

This order is effective today.

Dated ____________________, at San Francisco, California.

previously adopted amount should be reasonable and more than adequate, when compared to the $67.5 million which equated to $5 for each of the estimated 13.5 million access lines in California found reasonable for test year 1984.

26. AT&T-C should be required to produce better justification, in its next rate proceeding or rate investigation, that its "as allocated" marketing expenditures provide a proven cost benefit to its small, average, and large use customers, if it wants its customers to share such expenses.

27. Any future allocation of marketing expenses to AT&T-C's California operations should be performed by direct assignment based on need and benefit rather than on a percentage of revenue basis as used for this proceeding.

28. AT&T-C should be ordered to reduce its intrastate rates to eliminate any further overcollections in existing memorandum accounts established to track access charges, ULTS tracking, and Tax Reduction Act revisions by D.87-12-067, D.87-12-070, D.87-12-051, D.87-10-088, and D.88-01-061, and to bring its rates to the cost of service level adopted herein.

29. AT&T-C should be ordered to place $118.5 million in overcollected amounts as of July 1, 1988 into an interest bearing memorandum account to accrue interest at the average three-month commercial paper rate until refunds are made according to the method set forth herein.

30. AT&T-C's Advice Letter 97 reducing prospective rates below current costs of service, in lieu of refunds based on prior use, should be rejected.

31. A retrospective refund plan to return AT&T-C's overcollections with interest using recorded usage data for the past three months is reasonable, practicable and cost effective and should be adopted.

32. The retrospective refund method used to return overcollections to customers based on their recorded prior use for

a specific period of time is preferable to prospective rate reduction based on future use to reduce overcollections by future use at less than cost of service rates and more fully meets the spirit and intent of PU Code § 453.5 and should therefore be adopted in this proceeding.

33. Within 30 days after the effective date of this order, AT&T-C should be required to submit a refund plan, consistent with the discussion, findings, and conclusions adopted herein to return the overcollections with interest to its current and prior customers.

34. Customers claiming refunds for prior use on other than the basis set forth as the normal three-month recorded usage period herein should be required to present calculations of the refund and the supporting billing data therefor.

O R D E R

IT IS ORDERED that:

1. AT&T Communications of California, Inc.'s (AT&T-C) test year intrastate revenue requirement is reduced by $10.4 million effective January 1, 1987, from the level adopted on an interim basis in D.86-11-079, consistent with the preceding discussion and the adjustments adopted in this decision.

2. Within 10 days after the effective date of this order, AT&T-C shall file an advice letter in compliance with General Order 96-A, to eliminate the remainder of its existing surcharge, first authorized by Ordering Paragraph 20 of D.86-11-079, and adjust its long distance (including coin sent), 800, WATS and private line service to produce an overall annual revenue reduction, after uncollectibles, of $10.4 million on its California intrastate operations effective for service rendered on and after July 1, 1988, consistent with Ordering Paragraph 1 above. This Advice Letter shall further reduce intrastate rates by approximately an additional $163.6 million annually from existing rate levels to terminate any further overcollections resulting from the rate changes authorized by the following prior decisions effective July 1, 1988.

o	D.87-12-067	Pacific Bell	O.P. 35 & 38
o	D.87-12-070	GTE California	O.P. 1 & 2
o	D.87-12-051	Pacific Bell	O.P. 3
o	D.87-10-088	ULTS (Tracking)	O.P. 2
o	D.88-01-061	Tax Reduction Act	O.P. 1A

3. Effective July 1, 1988 AT&T-C shall place $118.9 million in overcollections estimated to that date, resulting from the prior decisions listed in Ordering Paragraph 2 above, coupled with the cost of service developed by this order, into an interest-bearing memorandum account to accrue interest at the average three-month commercial paper rate as published in the Federal Reserve Bulletin

until this amount with interest is refunded to its prior customers in-full, in accordance with the provisions of decision. In addition AT&T-C shall include in this memorandum account other identifiable amounts which become available for refund by July 1, 1988.

4. Within 30 days after the effective date of this order AT&T-C shall file a refund plan to flow through, with interest, on or before November 1, 1988 a one-time-credit to monthly bills, or refund to pre-July 1988 customers of record. This refund plan shall be consistent with the narrative discussion, findings and conclusions of this order and shall include the access charge and other reductions in expenses it received, or will receive as a result of this order and the decisions noted in Ordering Paragraph 2 above.

5. AT&T-C shall utilize the April 1 through June 30, 1988 period of intrastate usage for computing the available refunds with interest to its customers of record during that period and will use 90% of the funds in the memorandum account described in Ordering Paragraph 3 above for this standard refund offer.

6. AT&T-C shall hold back 10% of the amount in the memorandum accound described in Ordering Paragraph 3 above for use in response to fully supported claims for non-standard refunds by customers who had little use of AT&T-C's intrastate services during the April 1 through June 30, 1988 period or who had terminated their AT&T-C service during that or a prior period, but were customers of AT&T-C during at least a part of the period from March 1, 1986 through June 30, 1988 and who present a valid and fully supported claim for a refund.

7. Claims, for a non-standard refund, against the 10% holdback in the memorandum account shall be presented within 30 days of the receipt of AT&T-C's notice of the availability of such refunds or the provision of the standard refund credit on the customers monthly bill whichever occurs earlier.

8. AT&T-C shall take all steps practicable to complete the distribution of all non-standard refunds on or before December 31, 1988.

9. Any residual amount remaining in the memorandum account after completing the distribution of the non-standard refunds and earlier standard bill credits/or refunds shall be distributed equally to all of AT&T-C's customers of record during the month of February 1989, as a minor credit to their telephone bills.

10. Returned checks, if any, relative to this refund plan, after reasonable attempts to locate the lawful recipient, shall be dealt with in accordance with the laws of the State of California.

11. The notice or notices necessary to perfect this retrospective refund plan shall be drafted by AT&T-C and coordinated with the Commission Advisory and Compliance Division. At least one notice of this refund plan shall be included with a given monthly bill to all customers of all Local Exchange Companies operating in California, whether or not those customers are customers of AT&T-C.

12. On or before April 30, 1989 AT&T-C shall:

a. File an original and 12 copies of a report setting forth the results of its full compliance with this refund plan, with the Commission's Docket Office in San Francisco,

b. Enclose a letter of transmittal stating this proceeding and decision numbers, and

c. Attach a certificate of service to the transmittal letter showing service of the document by mail upon all parties to this proceeding.

13. The Commission Advisory and Compliance Division is responsible for reviewing AT&T-C's draft refund plan and notices therefor and AT&T-C shall direct all correspondence and supporting documentation regarding the plan to the Director of that division.

14. AT&T-C shall include with the Commission's copies of the advice letter filing and refund plan, described in Ordering Paragraphs 2 and 4 above, supporting workpapers setting forth the calculations for each of the rate changes and resulting rate reduction components and the overall rate reduction, as well as for the development of the amount to be set aside for refunds on July 1, 1988.

15. AT&T-C's Advice Letter #97 which proposes an alternative refund plan for its overcollections not adopted by this Commission is no longer needed and is hereby rejected today.

16. In addition to the requirement specified in Ordering Paragraph 3 of D.86-11-079, AT&T-C shall, in future rate proceedings, develop a cost/benefit justification showing that its marketing expenditures provide a proven cost/benefit to its small, medium, or large use customers.

17. Since this order resolves all 1986 test year issues held open in Ordering Paragraphs 2, 15, and 18 of D.86-11-079, this matter is closed.

audit hold-back of $15.1 million ($5.8 million on an intrastate basis) with no adjustments to its intrastate rate base. AT&T-C's request, if approved, would raise AT&T-C's intrastate revenue requirement for test year 1986 by $22.6 million as set forth in the following table.

The figures contained in the "Comparison of Adjustments" and Appendix C tables are rounded to the nearest $100,000 in accordance with the rounding practice used in D.86-11-079. Therefore, it follows that occasionally the dollar amount set forth in the summary tables may be $100,000 higher or lower than the adopted result in any given section of this order.

These rounding changes tend to average out and thus do not alter the significance of any given adjustment, or seriously affect the overall result.

Comments: ALJ's Proposed Decision

In accordance with PU Code Section 311 the ALJ draft decision prepared by ALJ George Amaroli was issued on May 11, 1988. Comments on the proposed decision were filed by the following interested parties: AT&T-C, DRA, California Association of Long Distance Telephone Companies (CALTEL), MCI Telecommunications Corporation (MCI), TURN, and U.S. Sprint Communications Company (U.S. Sprint).

These comments have been received and carefully considered by the Commission. Technical changes and corrections of errors necessitated by the comments have been incorporated in this final decision.

Certain portions of the "comments" were simply an extensive reargument of the parties' positions and merely supplemented the arguments previously briefed by AT&T-C and DRA, especially as pertain to marketing, customer service and billing, and the sale of the 195 Broadway property in the AT&T-C comments, and to a lesser extent customer service and billing in the DRA comments. In accordance with the Rules, we have not considered such rearguments in our deliberations.

A new Section XII is included in this final order which covers the matter of refunds of overcollections by AT&T-C. This new section considers and incorporates what we believe is the appropriate method of returning, in the form of refunds, certain overcollections accrued by AT&T-C over approximately the last two years. We hereby express our thanks to the commenting parties who all responded to the assigned ALJ's request for comments and expressions of concerns on the subject of refunds. We have used the comments and concerns received in the preparation of Section XII of this order.

On June 8, 1988 the assigned ALJ received the "Late-Filed Reply Comments" of AT&T-C, DRA, MCI, U.S. Sprint, and TURN. These late-filed reply comments were carefully reviewed, considered by the Commission, and incorporated where necessary in this decision. Comments received by the ALJ after June 8, 1988 were not available in time for incorporation into this order.

AT&T COMMUNICATIONS OF CALIFORNIA
Comparison of Adjustments
Phase II/A.85-11-029
Test Year 1986
(Thousands of Dollars)

		Total Company			Intrastate			Rev. Req. Effect		
		DRA Exh. 243	AT&T-C* Position	Adopted	DRA Exh. 243	AT&T-C* Position	Adopted	DRA Exh. 243	AT&T-C* Position	Adopted
	OPERATING EXPENSES									
1	Public Relations	$2,900	$0	$1,700	$1,100	$0	$600	$1,100	$0	$600
2	Reorganization	3,600	0	2,300	1,500	0	1,000	1,400	0	1,000
3	Allocation less Rev.	11,100	0	0	4,700	0	0	4,500	0	0
4	Allocation less Access & Rev.	5,200	0	5,000	2,100	0	2,000	2,000	0	1,900
5	Billing & Collection	79,100	0	46,100	20,100	0	9,100	19,100	0	8,700
6	Corp. Headquaters							4,000	0	2,100
7	AT&T-HQ	7,100	0	4,600	2,800	0	1,800			
8	Gain on 195 Broadway	2,300	0	0	900	0	0			
9	AT&T Tech.	2,700	0	1,000	1,200	0	500	2,100	0	1,300
10	American Transtech	200	0	200	100	0	100	100	0	100
11	R&D & Fund. Research	900	0	900	300	0	300	300	0	300
12	Marketing.	0	(39,700)	0	0	(18,000)	0	0	(17,100)	0
	Subtotals b/4 audit adj.	115,100	(39,700)	61,800	34,800	(18,000)	15,400	34,600	(17,100)	16,000
14	LESS: Audit adj. in D.86-11-079	15,100	15,100	15,100	5,800	5,800	5,800	5,500	5,500	5,500
15	Total Expense Adjustments	100,000	(54,800)	46,700	29,000	(23,800)	9,600			
16	Total Rev. Req. Effect							29,100	(22,600)	10,500
	RATE BASE									
17	AT&T Tech. Calif.	9,500	0	10,300	3,800	0	4,100			
18	Gain on 195 Broadway	5,900	0	5,200	2,300	0	2,000			
19	Total Rate Base Adjustments	15,400	0	15,500	6,100	0	6,100			

* As set forth in AT&T-C's Opening and Closing Briefs.
() Denotes increase in expenses or revenue requirement.

18. AT&T-C shall file copies of the reports, as set forth in Appendix D, to the addressees specified. This reporting requirement [except for those reports required by General Order 104 and the monthly earnings reports provided pursuant to Ordering Paragraph 8 of D.85-03-056 and General Order 65-A, and the record retention requirements of General Order 28-A] shall terminate upon submission of the reports for calendar year 1992, to be filed on or before March 31, 1993, unless earlier modified, extended, or discontinued by further order of this Commission. Should the Commission grant pricing flexibility to AT&T-C in its A.87-10-039, modifications to these requirements may be appropriate earlier. Parties are directed to discuss the appropriate nature of such modifications in A.87-10-039.

This order is effective today.

Dated JUN 17 1988, 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 dissent in part.

FREDERICK R. DUDA
Commissioner

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APPENDIX A
Page 1

Specific AT&T Corporate Headquarters
[Activity] Expenses Disallowed by the Staff
(As Identified by AT&T Witness Conrad J. Ankiel)

Functional Activity	Description of Activity
I Executive Administrative Expenses [Partial Disallowance]	General Administration of AT&T (including AT&T-C) -- salaries and expenses incurred by the senior executives and their support staffs.
II Public Relations Expense	
Media Relations	Conducting of press relations with national media in New York and Washington by responding to press inquiries and distributing information to the press.
EPCOT/INFOQUEST and Related Administration	Project expenses associated with EPCOT and INFOQUEST.
Corporate Archives and Information Resources	Maintenance and administration of the Corporate Archives/Provision of support services involving research, e.g. analysis of syndicated research data, periodical research, and deriving information from various available computer data bases.
Customer Satisfaction Advertising	Advertising campaign to inform selected constituencies of AT&T's dedication to satisfying customer's information/communications needs -- ads include AT&T Communications personages, long distance service reference, etc.
Ethnic Advertising	Advertising campaign directed toward Black and Hispanic audiences/ Ads build on the customer satisfaction campaign.
Thought Leader Advertising	Advertising campaign directed at vitally important constituencies, e.g. leaders of the business/

Functional Activity	Description of Activity
	financial community -- The campaign communicates the policies and philosophies of AT&T management so as to articulate the company's leadership role in communication and information services.
Corporate Advertising Administration	Administer the development and implementation of advertising programs to ensure that advertising effectively meets customer needs.
Advertising Liaison and Coordination	Coordination of advertising plans and media schedules for the AT&T entities/lines of business (LOB) so that consistent, cohesive and cost effective advertising is created which delivers intended messages to respective target audiences.
Corporate PR Strategies and Information	Establishment of AT&T's public relations strategic planning -- Identification and analysis of critical issues of significance to AT&T entities/LOBs.
Public Relations Survey Activities	Monitoring and assessing AT&T PR activities through surveys, questionnaires, etc.
Corporate Exhibits	Development and management of exhibits for special AT&T Corporate events such as shareowner meetings, community events, etc.
Corporate Underwriting Administration	Administration of corporate underwriting.
MacNeil/Lehrer News	Underwriting "The MacNeil/Lehrer NewsHour."
Cultural Programs	Sponsorship of quality arts programs.

Functional Activity	Description of Activity
Corporate Identity	Assure compliance throughout the entire corporation with all of the elements and requirements of the Corporate Identity Program.
Community and Educational Relations	Community and educational relations including: serving as a clearing house for the exchange of community and educational information; interfacing with consumer organizations and other public constituencies; and fulfilling corporate responsibilities to charitable, educational and cultural organizations.
III Legal	
Joint Venture, Mergers and Acquisitions	Service rendered in connection with legal matters relating to acquisitions, mergers and/or joint ventures.
IV Corporate Finance and Accounting	
Cash Management	Management of the AT&T pool of funds and temporary investments.
Tax Planning and Compliance - "Non-Utility"	Perform strategic and operational tax planning and research for non-utility tax matters, e.g. Federal withholding matters, state/local income taxes, property taxes, business and occupation taxes, capital stock taxes, sales/use taxes, net worth taxes and foreign taxes.
Data Systems Planning/ Information Movement and Management	Guide the activities of AT&T data systems development and support groups.
Financial Analysis	Provide the financial analysis function.

Functional Activity	Description of Activity
Business Planning and Analysis	Manage the AT&T planning process -- Prepare the schedule and guidelines for business plan submission, analyze financial view data provided, and produce the AT&T consolidated view of business plans.
AT&T Investor Relations	Maintain contacts with investors and the financial community.
Internal Audits CH	Perform internal audits as to the operations and activities of AT&T Corporate Headquarters and report results to management.
Joint Ventures	Represent the Finance Department in joint venture/merger/acquisition activity.
Corporate Financing	Provide goals, objectives and policies relating to capital markets, cost of capital, capital formation alternatives, and the impact of external factors on AT&T earnings and financing.
AT&T Foundation	Provide financial administrative support for the AT&T Foundation.
V Corporate Strategy & Development	
Corporate Strategy and Development	Development of integrated corporate plans including analyses and recommendations for the Office of the Chairman on business plans and corporate development options.
Corporate Planning Models	Provision of analytical models and analytical techniques associated with AT&T strategies.

APPENDIX A
Page 5

Functional Activity	Description of Activity
Venture Technologies	Provision of assistance in the identification, nurturing and implementation of internal ventures.
Corporate Communications	Formulation and monitoring of AT&T's corporate communications policy and objectives.

(Source: Ex. 236, Attachment C, Sheets 1-6.)

(END OF APPENDIX A)

APPENDIX B
Page 1

Glossary of Acronyms

A.	Application
ALJ	Administrative Law Judge
American	American Telephone and Telegraph Company (Predivestiture predecessor of AT&T)
AT&T[1]	AT&T Corporation (Parent)
AT&T Communications[1]	AT&T Communications, Inc. (same as NOMC)
AT&T-C[1]	AT&T Communications of California, Inc. (Applicant in this proceeding)
AT&T-CH[1]	AT&T-Corporate Headquarters
AT&TIS[1]	AT&T Information Systems, Inc.
BDP	Budget Decision Package
Bell Labs[1]	AT&T Bell Laboratories, Inc. (Called Bell Telephone Laboratories, Inc. before divestiture)
C.	Case
CACD	Commission Advisory and Compliance Division of the California Public Utilities Commission
Churn	Customer reselection of interexchange carriers after equal access initial selection was first made.
Cl. Br.	Closing Brief
CPI	Consumer Price Index
D.	Decision

1 See Summary of Decision section of this order for further details of AT&T's organizational structure.

APPENDIX B
Page 2

Glossary of Acronyms

DRA	Division of Ratepayer Advocates of the California Public Utilities Commission
E&C	Evaluation and Compliance Division (Predecessor of CACD)
Ex.	Exhibit
FCC	Federal Communications Commission
F/MBE	Female/Minority Business Enterprises
IEC	Interexchange carrier (such as AT&T-C, Allnet, Execulines, Inc., MCI, Starnet, U.S. Sprint, Western Union, and others)
LATA	Local Access and Transport Area
LEC	Local Exchange Company (One of the 22 telephone companies who provide local exchange and intraLATA telephone service in California. The term LEC's represents all 22 of these companies.)
LOB	Lines of Business
MTS	Message Toll [Telecommunications] Service
NARUC	National Association of Regulatory Utility Commissioners
NOI	Notice of Intent
NOMC[1]	AT&T Communications, Inc.-National Operations and Management Corporation
OII (also I.)	Order Instituting Investigation
Op. Br.	Opening Brief
PHC	Prehearing Conference

1 See Summary of Decision section of this order for further details of AT&T's organizational structure.

Glossary of Acronyms

POP	Points of Presence
PSD	Public Staff Division (Predecessor of DRA)
PT&T	The Pacific Telephone and Telegraph Company (Predivestiture predecessor of Pacific Bell)
PU Code	The California Public Utilities Code (Reference is usually followed by a section number.)
R&D	Research and Development
RD&D	Research, Development and Demonstration
ROI	Return on Investment
SNFA	Shared Network Facilities Arrangement
Technologies[1]	AT&T Technologies, Inc. (Post-divestiture successor to Western Electric Company, Inc.)
Tr.	Transcript
TURN	Toward Utility Rate Normalization (An intervenor, based in San Francisco, who represents residential and small business ratepayers)
USOA	Uniform System of Accounts
WATS	Wide Area Telephone Service
Western	Western Electric Company, Inc. (Predivestiture predecessor of AT&T Technologies, Inc.)

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1 See Summary of Decision section of this order for further details of AT&T's organizational structure.

(END OF APPENDIX B)

AT&T COMMUNICATIONS OF CALIFORNIA
Adopted Total Company & Intrastate Summary of Earnings
Phase II/A.85-11-029
Test Year 1986
(Thousands of Dollars)

		Total Company	Intrastate
	REVENUES		
1	Toll	$3,170,051	$1,705,524
2	Contracts	37,443	37,443
3	Uncollectibles	(62,708)	(26,095)
4	Total Revenues	3,144,786	1,716,872
	OPERATING EXPENSES		
5	Access Charges	1,901,993	1,103,678
6	Billing Charges	232,552	176,081
7	Maintenance	87,894	35,339
8	Depreciation	114,013	60,233
9	Traffic	145,254	56,649
10	Commercial	125,259	53,677
11	Operating Rents	93,431	39,744
12	Executive & Legal	5,090	1,930
13	Accounting	59,577	10,349
14	Relief & Pension	56,677	21,865
15	General	80,454	31,835
16	Other Expenses	(1,263)	(525)
17	Audit Adjustments	(52,958)	(11,754)
18	Subtotal	2,847,973	1,579,103
	TAXES		
19	CCFT	13,769	4,977
20	FIT	76,465	26,751
21	Gross Receipts	46,184	46,184
22	Other Operating Taxes	38,484	15,341
23	Total Expenses	3,022,875	1,672,356
24	Net Revenues	121,911	44,516
	RATE BASE		
25	Avg. Tel. Plant in Serv.	1,330,675	591,739
26	Avg. Plt. Under Const.-S. T.	0	0
27	Avg. Plt. Held for Fut. Use	275	155
28	Working Cash Allowance	77,660	43,248
29	Materials & Supplies	4,618	1,788
30	LESS: Depreciation Reserve	427,360	187,970
31	LESS: Deferred Taxes	165,811	80,399
32	Total Rate Base	820,057	368,561
33	RATE OF RETURN	14.87%	12.08%

AT&T COMMUNICATIONS OF CALIFORNIA
Revenue Requirement
Test Year 1986
(Thousands of Dollars)

	Results of Operations @ Present Rates	Adopted
1	Operating Revenues	$1,716,872
2	Operating Expenses and Taxes	1,672,356
3	Net Operating Revenues	44,516
4	Rate Base	368,561
5	Rate of Return	12.08%
	Revenue Requirement Calculations	
6	Estimated 1986 rate base	368,561
7	Adopted rate of return	12.35%
8	Net revenue requirement	45,517
9	Less: Estimated 1986 net revenues	44,516
10	Increase in net revenue requirement	1,002
11	Net-to-gross multiplier	1.8813
12	Increase in gross revenue requirement	$1,884

(END OF APPENDIX C)

APPENDIX D
Page 1

Reporting and Record-Keeping

A. Reporting Requirements

1. Nothing here is intended to change, revise, modify, or discontinue AT&T-C's regular reporting requirements under General Order 104 and its submission of monthly earnings reports pursuant to Ordering Paragraph 8 of D.85-03-056 and General Order 65-A, or the preservation of records as specified in General Order 28-A.

2. AT&T-C shall, on or before March 31, 1989, and in each subsequent year, submit to the Deputy Director of the Division of Ratepayer Advocates, an original and one copy of a report detailing transactions between AT&T-C and Technologies, during the past calendar year. The report will contain:

a. AT&T-C's construction budget.

b. Amount of AT&T-Communications of California's purchases from Technologies (estimated for expense and plant categories), and

c. Capital structure of Technologies.

AT&T-C and Technologies shall arrange to retain, but not report annually, respective accounting records, including such memorandum accounts as necessary, in a manner which would permit the development of "Realized rate of return of Technologies sales to AT&T-C of California by line of business," for AT&T-C's next rate application or rate investigation. The original of the report required herein will be routed by DRA's Deputy Director to the Director of the Commission Advisory and Compliance Division for compliance review by that division and then to the formal file in this proceeding for access and review by interested parties.

This new reporting requirement shall terminate upon submission of the reports for calendar year 1992, to be filed on or before March 31, 1993, unless earlier modified, extended, or discontinued by further order of this Commission.

B. <u>Record-keeping Requirements</u>

AT&T-C shall arrange with AT&T-CH and AT&T-Communications (NOMC) to maintain those accounting records and memorandum accounts necessary to respond promptly to DRA's requests for information regarding the following activities and categories of expenses in its next rate proceeding:

- Corporate Reorganizations
- Advertising and Marketing Cost/Benefits
- Billing and Collection Program Development and Deployment
- "Side Records" as a proxy for Account 674 data per D.87-12-063.
- Corporate Headquarters Allocations
- AT&T Communications (NOMC) Headquarters and Field Allocations

These record-keeping requirements, in anticipation of future rate proceedings, are more precisely, but not exclusively, defined as follows:

1. <u>Corporate Reorganization</u>

Tracking records for reorganizations would include the following DRA requested information:

"a. The implementation plan including a schedule of staff changes, whenever this information becomes available;

"b. Track all costs associated with the reorganization plan, including employee relocation costs, by organization and type identifying direct and shared costs;

"c. Maintain monthly reports on costs tracked;

"d. Identify the total effect of these costs in allocations to California;

"e. Provide a final report upon completion of reorganization including the total economic impact."

2. Advertising and Marketing Cost/Benefits

AT&T-C shall arrange to maintain accounting records and memorandum accounts, as necessary, to permit it to comply with Ordering Paragraph 5 of this decision when it files any future rate application, as follows:

"In future rate proceedings, if AT&T-C wishes California ratepayers to bear a share of allocated advertising and marketing expenses, it shall present a cost/benefit analysis in its direct showing, over the latest available 12-month recorded period, as well as its pro forma analysis of future commercial expenses. This analysis should be developed to include justification that its marketing expenditures provide a proven cost/benefit to its small, medium, and large use customers."

3. Customer Service and Billing Program

AT&T-C is authorized to place $9.1 million of the California intrastate expenses, so allocated from AT&T's development and deployment of its customer service and billing program, into an interest-bearing memorandum account to accrue interest at the average three-month commercial paper rate as published in the Federal Reserve Bulletin. This will permit AT&T-C to recover these costs upon a further determination of prudency of AT&T-C's take-back of its message billing service from the LECs and its own introduction of direct billing, which will necessarily be a future rate proceeding.

4. General Expenses of Corporate Headquarters

Pursuant to D.87-12-063 issued December 22, 1987 in I.87-02-023, AT&T-C was exempted from a requirement to reinstate "Account 674, General Services and Licenses." However, in lieu thereof, D.87-12-063 contained the following proviso which will apply to DRA's request for future reporting requirements herein as well:

> "g. AT&T shall maintain its data on affiliate company costs on a side record basis and shall not be required to set up a separate and unique subaccount code to record these costs." (D.87-12-063, mimeo. p. 48.)

5. <u>Allocation of Corporate Expenses</u>

AT&T-C, in cooperation with AT&T-CH and AT&T Communications (NOMC), should wherever possible use more direct allocations of headquarters expenses for rate-fixing purposes where the direct beneficiaries can be identified.

AT&T-C, in cooperation with AT&T Communications (NOMC), should discontinue the use of access charges in allocation factors.

The record-keeping requirements set forth in B.1 through B.5 above shall terminate, except for Item B.4, upon the conclusion of AT&T-C's next general rate proceeding or calendar year December 31, 1993, whichever occurs later, unless earlier modified, extended, or discontinued by further order of this Commission.

(END OF APPENDIX D)

A.85-11-029
D.88-06-036

Commissioner Duda, Dissenting in Part:

I feel the need to explain why I believe that the refund proposed by ALJ Amaroli is superior to the prospective rate reduction authorized by today's decision.

As the ALJ pointed out, avoidance of all review of prior customer usage and the setting of future rates at less than cost in order to amortize the prior overcollections through future rate reductions is both unreasonable and unfair. Such a method sends a signal to customers that they must purchase additional service, whether they need it or not, to receive through bargain rates an amount equal to their prior overpayment.

The ALJ's refund proposal was carefully tailored to give the excess money collected by AT&T-C back to those AT&T-C customers and former customers who overpaid in the first place. The adopted decision, however, instead only benefits present customers of AT&T-C who, in the next six months, make as many, or more, long distance calls than they did in the past six months.

As the ALJ further points out, the use of future rate reductions to refund past overcollections is also unfair to AT&T-C's interexchange carrier competitors. By allowing AT&T-C to price its services well below cost, AT&T-C gains a considerable competitive advantage over its business rivals. While major rivals such as US Sprint and MCI may grudgingly take this in stride, the effect of today's decision will be much more serious for the dozens of smaller interexchange carriers operating in California.

A.85-11-029
D.88-06-036

Today's decision sends the signal that we are willing to grant the dominant player in the long-distance marketplace a very significant competitive advantage simply because to do so is easier than making even a minimal effort to match up the prior overcollections with the customers who have contributed to those overcollections. This signal seems contrary to our profession of interest in ensuring the viability of a competitive long-distance marketplace.

Support for a one-time refund can easily be found here from the facts. The application of Public Utilities Code 453.5 (as guided by the Supreme Court's direction to us in the Cory and California Manufacturers' cases) strongly supports the reasonableness of a one-time refund. I would so order.

Frederick R Duda

Frederick R. Duda, Commissioner

June 17, 1988
San Francisco, California