ALJ/CLF/jt

Decision 89 12 048 DEC 18 1989

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of Alternative Regulatory Frameworks for Local Exchange Carriers.	I.87-11-033 (Filed November 25, 1987)
In the Matter of the Application of Pacific Bell (U 1001 C), a corporation, for authority to increase intrastate rates and charges applicable to telephone services furnished within the State of California.	Application 85-01-034 (Filed January 22, 1985; amended June 17, 1985 and May 19, 1986)
Application of General Telephone Company of California (U 1002 C), a California corporation, for authority to increase and/or restructure certain intrastate rates and charges for telephone services.	Application 87-01-002 (Filed January 5, 1987)
And Related Matters.	I.85-03-078 (Filed March 20, 1985) OII 84 (Filed December 2, 1980) C.86-11-028 (Filed November 17, 1986) I.87-02-025 (Filed February 11, 1987) C.87-07-024 (Filed July 16, 1987)

(See Decision 88-08-024 and Decision 89-10-031 for appearances.)

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I N D E X

INTERIM OPINION ADOPTING STARTUP REVENUE ADJUSTMENTS UNDER NEW REGULATORY FRAMEWORK

I. Summary of Decision

In Decision (D.) 89-10-031, the Commission adopted a new incentive-based regulatory framework for Pacific Bell (Pacific) and GTE California Incorporated (GTEC). D.89-10-031 provided that rates established under this new regulatory framework will become effective on January 1, 1990 based on compliance filings which Pacific and GTEC were required to make in Investigation (I.) 87-11-033 no later than October 26, 1989. Today's decision adopts startup revenue adjustments for Pacific and GTEC. We also address petitions for modification of D.89-10-031 filed by GTEC and the Division of Ratepayer Advocates (DRA) as well as the petition for modification of D.89-10-031 filed by Toward Utility Rate Normalization (TURN) to the extent it addresses startup revenue adjustment issues. Other portions of TURN's petition for modification of D.89-10-031 will be addressed in a subsequent decision. Table 1 and Table 2 show recommended and adopted revenue adjustments for Pacific and GTEC, respectively.

We adopt a $390,554,000 revenue reduction for Pacific, compared to Pacific's modified request of a $238,602,000 decrease. Of the difference between Pacific's proposal and the adopted adjustment, $42,590,000 is due to our omission of the revenue impacts of three issues which will be considered in other proceedings. While we have established that rates should be adjusted for these items, we will determine the exact amounts in further decisions in 1990. Thus, Pacific will receive additional revenues up to this amount in 1990 as a result of these issues still pending.

We adopt a $32,224,000 revenue increase for GTEC, compared to GTEC's modified request of a $41,626,000 increase. Of this amount, only a $593,000 revenue decrease due to direct assignment of Wide Area Telephone Service (WATS) adjustments will be implemented on January 1, 1990. In order that there be only one net revenue adjustment later in 1990, we authorize GTEC to record the remaining net increase of $32,817,000 in a memorandum account. Only one issue, which could result in a revenue reduction of $2,443,000, remains pending for GTEC.

We also implement certain SPF-to-SLU shifts authorized by prior decisions.

Table 1
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Recommended and Adopted
Startup Revenue Adjustments

Pacific Bell
($000)

	Pacific*	DRA**	Adopted*
1989 ADJUSTMENT:			
1989 Annualized Results	$(324,780)	$(440,375)	$(324,780)
Issues Requiring Tariffed Rate Determination:			
Compensated Absences	36,850	0	0
Expense Limit Increase	14,640	0	0
Annualization Issues:			
AT&T Billing & Collections	11,000	0	11,000
Labor Contract	11,910	0	0
Reprice of 800 Service	18,000	0	2,850
Separations Change for COE and Revenue Accounting Expenses	3,760	0	3,760
Productivity Refund Accrual	0	0	(45,400)
TOTAL 1989 ADJUSTMENT	(228,620)	(440,375)	(352,570)
1989/90 SETTLEMENTS ADJUSTMENT:			
USOAR Settlements Update	11,750	0	-
GTEC Settlements Trueup	(84,010)	0	-
TOTAL SETTLEMENTS ADJUSTMENT	(72,260)	0	(72,260)

Table 1
(Page 2 of 2)

Recommended and Adopted
Startup Revenue Adjustments

Pacific Bell
($000)

	Pacific*	DRA**	Adopted*
1990 PRICE CAP ADJUSTMENT:			
GNP-PI - 4.5%	$ 26,604	$ 8,646	$ 26,202
Exogenous Factors:			
Separations Change for COE and Revenue Accounting Expenses	7,520	0	7,520
Separations Change in Apportioning Local Switching Costs Based on DEM Minutes	10,910	10,910	10,910
Fire Suppression	10,700	0	0
Asbestos Survey and Removal	4,800	0	0
USOAR Turnaround	0	(111,000)	(21,000)
Direct Assignment of WATS***	(356)	(1,424)	(356)
Tax Benefits from Bond Retirement	(8,900)	(8,900)	0
Depreciation Represcription	0	(45,000)	0
TOTAL PRICE CAP ADJUSTMENT	51,278	(146,768)	23,276
INFRASTRUCTURE EXPENSE	11,000	11,000	11,000
TOTAL ADJUSTMENT	(238,602)	(576,143)	(390,554)

* Based on 8 months ending August 31, 1989 annualized.
** Based on 7 months ending July 31, 1989 annualized.
*** Pacific includes this adjustment in its intraLATA SPF-to-SLU adjustment.

Table 2

Recommended and Adopted
Startup Revenue Adjustments

GTE California
($000)

	GTEC*	DRA**	Adopted*
1989 ADJUSTMENT:			
1989 Annualized Results	$ 26,453	$ 30,571	$ 26,453
Annualization Issues:			
Reprice of 800 Service	8,250	0	520
Productivity Refund Accrual	0	(1,714)	(3,000)
TOTAL 1989 ADJUSTMENT	34,703	28,857	23,973
1990 PRICE CAP ADJUSTMENT:			
GNP-PI - 4.5%	7,752	2,519	7,107
Exogenous Factors:			
Separations Change in Apportioning Local Switching Costs Based on DEM Minutes	11,291	9,091	11,291
USOAR Turnaround	(11,527)	(11,527)	(11,527)
Direct Assignment of WATS	(593)	(593)	(593)
Tax Benefits from Bond Retirement	0	(2,443)	0
Depreciation Technical Update	0	3,000	0
Interstate Universal Service Fund Change	0	0	1,973
TOTAL PRICE CAP ADJUSTMENT	6,923	47	8,251
TOTAL ADJUSTMENT	41,626	28,904	32,224

* Based on 8 months ending August 31, 1989 annualized.
** Based on 7 months ending July 31, 1989 annualized.

II. Background

Under the new framework adopted in D.89-10-031, rates for Pacific's and GTEC's basic monopoly services and rate caps for flexibly priced services will be indexed annually according to the Gross National Product Price Index (GNP-PI) inflation index reduced by a productivity adjustment of 4.5%. The indexing formula also allows for rate adjustments for a limited category of exogenous factors (Z factors) whose effects are not reflected in the economywide GNP-PI.

The price cap indexing formula was adopted with its first application to be to set rates effective January 1, 1990. However, we concluded based on recorded earnings levels for the early months of 1989 that, particularly for Pacific, application of the indexing formula to current rates as the base for 1990 rates would result in earnings for 1990 significantly above the 11.5% market-based rate of return adopted for Pacific and GTEC. As a result we ordered Pacific and GTEC to make compliance filings providing information to allow a startup revenue adjustment so that 1990 rates are reasonably expected to produce earnings equal to the market-based rate of return. D.89-10-031 describes the rate adjustment approach as follows:

> "The first step is to determine, working from recorded 1989 revenues, what 1989 rates (excluding the temporary surcredits which will expire by the end of 1989) would have had to be to yield the market-based 1990 rate of return in 1989. [Footnote omitted.] Those hypothetical rates will then be adjusted by application of the price cap index.
>
> "In this calculation, exogenous factors which meet the established criteria for recognition as 'Z factors' should be included in the price cap index. Any other rate or revenue impacts that have been approved in a Commission resolution or decision should also be included as adjustments to the startup revenue adjustment in the manner we have previously

considered such impacts in annual attrition adjustments." (D.89-10-031, p. 299.)

The decision ordered Pacific and GTEC to base the startup revenue adjustments proposed in their compliance filings on recorded results for the first eight months of 1989 as shown in their monthly results of intrastate operations reports filed with the Commission Advisory and Compliance Division (CACD). We also provided that Pacific and GTEC should include the surcredit/surcharge effects of previously authorized interLATA and intraLATA SPF-to-SLU shifts in their compliance filings, rather than making separate advice letter filings as previously authorized for this purpose.

Following receipt of Pacific's and GTEC's compliance filings, various other filings were made as provided by the assigned Commissioner and assigned Administrative Law Judge (ALJ). In addition to Pacific, GTEC, DRA, and TURN, the following parties made one or more filings regarding implementation of the startup revenue adjustment provided by D.89-10-031:

AT&T Communications of California, Inc. (AT&T)
Bay Area Teleport (BAT)
California Cable Television Association (CCTA)
MCI Telecommunications Corporation (MCI)
US Sprint Communications Company Limited Partnership (US Sprint)

Workshops on the compliance filings were also held on November 17 and November 28, 1989 which were chaired by ALJ Ford.

III. Startup Revenue Adjustment

A. 1989 Annualized Results

Pacific calculated that annualization of operating results from the first eight months of 1989 indicates a negative $324.78 million revenue impact when adjusted to meet the 11.5% market-based rate of return. Using comparable calculations, GTEC shows that the adjustment to its annualized results of operations based on the first eight months of 1989 to yield an 11.5% rate of return would be a $26.453 million revenue increase. The primary issue surrounding the utilities' annualization calculations is whether six or seven months of data rather than eight months of recorded results should be used as the basis for the annualization. This issue arose because of materially different results for August 1989 which Pacific showed in its compliance filing.

Pacific's compliance filing shows the following rates of return for the first eight months of 1989:

	Rate of Return
January	14.60%
February	13.27%
March	15.54%
April	13.87%
May	13.58%
June	14.22%
July	13.14%
August	8.69%

Upon reviewing Pacific's compliance filing, the assigned Commissioner required that Pacific make a supplemental filing providing an explanation and accounting of the significant decrease in August results. Pacific and GTEC were also required to restate their startup revenue adjustments and other financial figures in their compliance filings using data from the first seven months of 1989 annualized.

In its supplemental filing submitted November 7, 1989 in response to the assigned Commissioner's ruling, Pacific identified several items which account for most of the variance in August results. The first of these adjustments is a $28.6 million revenue reduction in August, accompanied by a booked $1.4 million interest expense, to recognize the first eight months of a customer refund anticipated as a result of the labor productivity incentive plan adopted in D.87-12-067. The second is a $38.5 million reduction in revenues to reflect an out-of-period settlements adjustment with GTEC. Pacific also recognized an incremental increase in wages and benefits of $6 million in August as a result of new collective bargaining agreements, including the booking of $3.7 million to cover eight months of expense for a "Team Award" included in its new labor agreements and retroactive to January 1989. Pacific also notes that revenues were lower in August relative to early 1989 due to lower rates for Pacific's 800 service and a monthly booking which had commenced in July to match the revenue reduction ordered by Resolution T-13073 due to the new AT&T billing and collection contract.

If the startup revenue adjustment is based on seven rather than eight months of recorded data, Pacific asks that explicit adjustments be made to recognize the expected productivity refund, the booked out-of-period settlements effect, and increased labor costs.

In its supplemental filing, GTEC notes that in August it booked contract wage increases paid to its bargaining unit employees for the period March 5 through August 31, 1989, since its new labor agreement was ratified on August 7, 1989 and applies retroactively to March 5, 1989. If the Commission elects to modify D.89-10-031 so that seven months of recorded data are used to calculate the startup revenue adjustment, GTEC requests that the Commission recognize the 1989 impact of its contractual wage increases for March through July even though they were not booked during that period.

DRA and TURN argue both in petitions to modify D.89-10-031 and in their responses to Pacific's and GTEC's compliance filings that the Commission should rely on only the first six or, at most, seven months of recorded data for 1989 as the basis for the startup revenue adjustment. DRA asserts that the material difference between Pacific's reported results of operations for August compared to prior months' results raises substantial questions which would require time to review and analyze. TURN likewise argues that the Commission would give up little accuracy by using six months instead of eight and would benefit from exclusion of controversial data. DRA bases its recommendations regarding startup revenue adjustments on seven months' data, as shown in Table 1 and Table 2. US Sprint and MCI similarly argue in their comments against reliance on August results.

In its response to DRA's petition for modification, Pacific notes that if the first eight months' actual results for 1989 were restated to reflect revenue impacts of productivity sharing and GTEC settlements in the months to which they apply rather than in August, the August rate of return would rise to 12.16%, in line with the restated returns for earlier months.

As DRA recognizes in its supplemental comments filed on November 16, 1989, Pacific has identified adjustments it made to its August 1989 results which account for all but $11.5 million of the variance from average results for January through July of 1989. In subsequent sections of this decision, we examine the appropriateness of each of the August adjustments made by Pacific. Pacific has shown that August's results, taking into account the identified adjustments, are not out of line with results for earlier months. Because of this and since as a general principle reliance on results for both GTEC and Pacific from as much of 1989 as possible should yield increased accuracy, we find reasonable and reaffirm the requirement in D.89-10-031 that the startup revenue adjustment be based on recorded results from the first eight months of 1989. As result, DRA's petition for modification of D.89-10-031 and TURN's petition for modification of D.89-10-031 to the extent it addresses this issue should be denied.

In its comments on Pacific's compliance filing, TURN also asks that the Commission modify use of the average rate base for the first eight months of 1989 in computing annual returns, and suggests that the rate base figure from the most recent month recorded would provide a more accurate estimate of the eventual annual average rate base. Pacific responds that use of such a limited time frame would inaccurately represent the 1989 rate base and further that it is inappropriate for TURN to attempt to modify D.89-10-031 through comments on Pacific's compliance filing.

TURN's proposal is comparable to arguments discussed in Section III.C regarding whether certain annualization issues should be considered. While it is uncontroverted that Pacific's rate base is declining, we do not wish to open up the compliance filings for consideration of which ongoing cost changes are likely to increase and which are likely to decrease net earnings in the last four months of 1989, since to do so would run counter to our intent in D.89-10-031 that startup revenue adjustment issues be resolved in a timely fashion so that the new regulatory framework with its significant ratepayer benefits can be implemented on January 1, 1990. As a result, TURN's request is denied.

No party questions the numerical accuracy of the calculations Pacific and GTEC performed to adjust the annualized eight months' recorded results to yield an 11.5% rate of return. As a result, and since we have found that eight months rather than seven months of data should be used and that no adjustment should be made to the rate base, we adopt Pacific's and GTEC's numerical calculations as reasonable. In subsequent sections, we address whether Pacific's August bookings were properly made.

Various parties propose adjustments to the 1989 annualized results which they assert are appropriate as part of the first step in the startup revenue adjustment, which is to "determine, working from recorded 1989 revenues, what 1989 rates... would have had to be to yield the market-based 1990 rate of return in 1989" (D.89-10-031, p. 299). These proposed adjustments are discussed in the following sections.

B. Issues Requiring Tariffed Rate Determination

Pacific proposes three adjustments to the eight months' actuals annualized to reverse its accrual of revenues booked in anticipation of Commission decisions which have not yet been issued. Pacific asserts that it has incurred actual expenses for these items but has not yet received compensating revenues. Thus, it argues, its adjustments merely reflect reality. Pacific suggests that the proposed rate adjustments could be made subject to refund pending further Commission review, in order to forestall future rate increases.

Two of these adjustments, arising from an FCC-approved change in the treatment of compensated employee absences and an increase in the purchase price limit of certain items which allows expense rather than rate base treatment, are discussed in this section. We find it more appropriate to address the settlements issue raised by Pacific regarding the Uniform System of Accounts (USOA) rewrite in conjunction with other settlements issues in Section III.E of this decision.

Pacific made an adjustment of $36.85 million to reverse accruals for recovery of revenue requirement impacts of USOA revisions in treatment of compensated employee absences. According to Pacific, this amount represents the 1989 portion of compensated absences effects excluded from Pacific's USOA balancing account, plus interest. GTEC indicates that it has always booked expenses for compensated absences in a manner consistent with the new FCC requirements and that this approach has been recognized in the past in setting GTEC's rates. As a result, GTEC submits that no revenue adjustment for compensated absences expenses is appropriate for GTEC.

Pacific also made an adjustment of $14.64 million to reverse accruals booked in anticipation of approval of Advice

Letter No. 15544 dated April 28, 1989 seeking authorization to apply revised USOA Part 32 rules increasing expense limits from $200 to $500 for purchases of certain telephone plant on an intrastate basis. While GTEC likewise had filed an advice letter requesting adoption of the FCC change on an intrastate basis, GTEC states that it did not reflect this accounting change in its compliance filings because it had not yet been adopted by the Commission.

Several parties oppose Pacific's adjustments as being contrary to D.89-10-031. TURN and US Sprint argue that any adjustments in previously accrued expenses and revenues are inappropriate unless a full review is performed which might uncover offsetting expense or revenue adjustments in other categories. DRA, TURN, and AT&T emphasize that if Pacific reverses booked revenues, it should be required to reverse corresponding expenses as well. DRA asserts that the amounts of these adjustments are speculative and litigious and that their inclusion is inappropriate in what was supposed to be a noncontroversial filing.

D.88-09-030 requires that Pacific file an advice letter for recovery of its compensated absences impact. DRA challenges Pacific's requested revenue recovery as being significantly too high, for reasons detailed in an appendix to its comments, and states that it would protest Pacific's advice letter when filed. During the workshop, Pacific indicated that it plans to file an advice letter addressing this issue as soon as discussions with DRA are concluded, with an anticipated date being either before the end of 1989 or early 1990.

On November 22, 1989, the Commission issued Resolution F-626 adopting the FCC's Part 32 USOA expense limit change for intrastate ratemaking purposes, effective retroactive to January 1, 1989 at the option of the local exchange carriers. Resolution F-626 provided, however, that any revenue requirement increases sought by the telephone companies should be through an application and should include potential cost or productivity savings which might result from implementing this accounting change.

The effective result of the two adjustments Pacific requests at this time for compensated absences and the $200 to $500 expense limit increase would be to put these items in rates before the Commission has had an opportunity to review the reasonableness of Pacific's expense estimates. Since we have made provision for such review (through an advice letter for compensated absences and an application for the expense limit increase), we agree with DRA that it would be premature to take such a step at this time. As a result, we will not make the adjustments Pacific proposes, thus effectively removing both accrued revenues and booked expenses associated with compensated employee absences and the $200 to $500 expense limit increases from 1989 results used as the basis for startup revenue calculations.

Pacific may request rate recovery of these cost increases as previously provided by the Commission in D.88-09-030 and Resolution F-626. In its filings, Pacific should indicate whether there are year-to-year changes in rate impacts so that these issues should be recognized as exogenous factors (Z factors) in the new price cap indexing mechanism for 1990 or subsequent years.

C. <u>Annualization Issues</u>

Pacific proposes four additional adjustments to the eight months' actuals annualized to reflect items which it asserts cannot be properly annualized by multiplying by a 1.5 factor as discussed on page 300 of D.89-10-031.

Several parties object to these positive adjustments absent an opportunity for parties to investigate for possible items that would decrease revenue requirements. DRA cites factors such as overall revenue growth, declining expenses due to productivity gains, and rate base decreases which would serve to decrease revenue requirements if identified. While it believes that D.89-10-031 did not intend annualization adjustments, DRA asks for an opportunity to seek out similar adjustments if the Commission decides to allow exceptions to the annualization method prescribed in D.89-10-031.

Pacific replies that the Commission should not blindly apply the 1.5 annualizing factor without any consideration of whether results would be distorted, and argues that the Commission sought instead to simply reflect 1989 actual results. Pacific further argues that its annualization adjustments comport with the Commission's determination that:

> "[a]ny other rate or revenue impacts that have been approved in a Commission resolution or decision should also be included as adjustments to the startup revenue adjustment in the manner we have previously considered such impacts in annual attrition adjustments." (D.89-10-031, p. 299.)

Pacific asserts that DRA seeks to expand annualization adjustments to include adjustments unrelated to Commission actions. Pacific states that it is unaware of any material annualization adjustments other than those included in its compliance filing.

We agree with Pacific that consideration of annualization issues should be limited to only rate or revenue impacts which have been approved in a Commission resolution or decision, consistent with D.89-10-031. To allow adjustments for other expense or revenue changes would, as DRA asserts, require for balance a reasonable opportunity for other parties to evaluate and propose additional annualization adjustments, which would run counter to the intent of D.89-10-031 that the startup adjustment filings be relatively straightforward to allow implementation of the new regulatory framework by January 1, 1990.

1. <u>AT&T Billing and Collections</u>

Pacific made an adjustment of $11 million to decrease annualized revenues to reflect the full annualized extent of the requirement in Resolution T-13073 dated June 21, 1989 that Pacific flow through to its ratepayers the incremental revenue requirement effects of its new Billing and Collection Special Service Arrangement with AT&T.

The incremental revenue requirement effect for 1989 is a revenue reduction of $22 million. Beginning in July 1989, Pacific reflects $3.667 million (1/6 of the $22 million to be refunded for 1989) monthly. Using the authorized annualizing formula, the result is only an $11 million revenue reduction for 1989 rather than the $22 million known impact. Pacific asserts that annualized revenues should therefore be reduced by an additional $11 million so that the entire $22 million 1989 revenue reduction impact of Resolution T-13073 is recognized.

Since this revenue reduction is a known effect of a prior Commission resolution, we agree with Pacific that it is properly recognized as an adjustment to 1989 annualized results and adopt this adjustment. Pacific should address as part of its October 1, 1990 advice letter filing required by D.89-10-031 whether a 1991 Z factor adjustment would be appropriate in light of this adjustment.

2. <u>New Labor Contracts</u>

Pacific made an adjustment of $11.91 million to decrease the annualized revenue adjustment to reflect increased wage and benefits expenses due to new collective bargaining agreements. Because the increased wage and benefit expenses are effective in August, Pacific asserts that this adjustment is needed to accurately reflect the correct amount of increased expense Pacific will incur in 1989.

DRA, TURN, and MCI argue that this adjustment should not be allowed on the basis that it represents an ordinary event in the course of business and that Pacific is compensated for such cost increases through application of the indexing mechanism. TURN notes that Pacific's projected labor contract results are consistent with current inflation estimates.

Pacific responds that parties have misinterpreted the nature of this adjustment: rather than a Z factor for 1990 in the price cap indexing mechanism, the wages and benefits adjustment is made solely to reflect actual 1989 results for startup purposes. Pacific submits that the Commission recognized this increase in wages and benefits expenses in Resolution T-13037 (Pacific's 1989 attrition resolution) and authorized rates accordingly; Pacific argues that failure to appropriately reflect these wages and benefits expenses in the startup calculation would effectively result in elimination of the Commission's previously authorized recovery of these expenses.

Pacific mischaracterizes the treatment of wages and benefits expenses in Resolution T-13037, which states that "(t)he contractual wage increases and team incentive awards are based on its current contract, which expires in August 1989." Resolution T-13037 recognized the then-current contract only for the purpose of forecasting growth in composite salary and wages, one of the many forecasted factors used to determine a reasonable level of rates under the attrition procedure. This contrasts with the attrition treatment of revenue impacts of Commission decisions or resolutions for which revenue impacts found reasonable by the Commission were subsequently factored into the next year's rates. Pacific's new labor contract has not been recognized in a Commission resolution or decision. Because of this, we find that Pacific's new labor contract does not meet the criterion in D.89-10-031 cited by Pacific that allows adjustments for rate or revenue impacts previously approved by the Commission and do not allow this adjustment proposed by Pacific.

As noted previously, in August Pacific and GTEC booked retroactive wage increases arising from new labor agreements. Since these reflect actual labor costs incurred during the first eight months of 1989, we find these bookings reasonable.

3. <u>Reprice of 800 Service</u>

Pacific made an adjustment of $18.0 million to decrease annualized revenue to reflect the impact of new rates for its intraLATA Half State and Full State 800 service, which became effective July 5, 1989 pursuant to Advice Letters 15557 and 15557A. Pacific states that use of the annualizing formula in D.89-10-031 is inappropriate because the rate decrease did not become effective until July 5, 1989. It asserts that the impact for July 5 through August 31 was a reduction of $8.8 million in revenues whereas the reduction for July 5 through December 31 is expected to be $31.2 million.

AT&T and MCI question the reliability of Pacific's current revenue impact estimates, pointing out that in Advice Letter No. 15557A Pacific stated the 1989 annual revenue effect of its 800 service reprice is a $5.7 million decrease. AT&T asserts that Pacific should not be allowed to claim the effect of a single advice letter that is materially different from the original estimate without updating all other 1989 advice letters.

Pacific replies that AT&T misunderstands what the $5.7 million figure represents, and explains that it represents the incremental difference in revenue loss between two scenarios: (1) changing rates in accordance with the advice letters and (2) no change in rates. Pacific asserts, however, that the total revenue loss is $31.2 million. In response to questions from the ALJ at the November 28 workshop, Pacific staff confirmed that the $31.2 million revenue loss was calculated by comparing what revenues would have been if the existing customer base had been billed at old rates relative to billings to those customers at current rates, with an assumption that there is no customer loss due to market forces or competition. On the other hand, the $5.7 million revenue loss cited in Advice Letter No. 15557A recognizes that significant customer loss would occur absent repricing of this service.

GTEC notes that since it concurs in Pacific's rates for intraLATA 800 service it will also incur revenue loss as a result of Pacific's price reduction. While GTEC did not reflect this impact in its compliance filing, in its December 1 filing GTEC submits that based on new information from Pacific the price change increases GTEC's 1989 startup revenue adjustment by $8.25 million.

Based on Pacific's explanation of its proposed adjustment, we conclude that Pacific incorrectly attempts to attribute to Commission action revenue losses which are actually due to market forces. Assuming Pacific's revenue and customer retention estimates are correct, the Commission's authorization of intraLATA 800 service price reductions reduces revenues by only $5.7 million; the additional revenue loss cited by Pacific would occur in any event. We conclude that Pacific's proposed adjustment should not be made because it runs counter to the intent of D.89-10-031 to consider only rate or revenue impacts arising directly from regulatory action. Since only a $5.7 million revenue loss is attributable to Advice Letter No. 15557A, we conclude that only this amount should be reflected in 1989 adjusted results. Recognizing that revenue losses due to the 800 service rate adjustment were reflected in recorded results for July and August, we conclude that a revenue adjustment of $2.85 million would be appropriate to correct annualized results for the full impact of 800 service repricing. The comparable adjustment we adopted for GTEC is $520,000.

4. Separations Change for Central Office Equipment and Revenue Accounting Expenses

Pacific made an adjustment of $3.76 million to reflect increased expense due to separations changes for central office equipment and revenue accounting expenses, as recognized in Resolution T-13037. While these jurisdictional separations changes were effective on April 1, 1989 and reflected in intrastate expenses after that date, the associated revenues authorized in

Resolution T-13037 will be realized evenly throughout all 12 months of 1989. Pacific asserts that annualization of the first eight months' results understates these expenses by $3.76 million.

GTEC states that it included the impacts of these separation changes in its 1989 jurisdictional allocation factors for all of 1989 and therefore that no revenue adjustment is needed comparable to that requested by Pacific.

We agree with Pacific that annualization of eight months' results understates expenses associated with this separations change by $3.76 million. Since Resolution T-13037 authorized revenue recovery of the effects of this separations change, we conclude that Pacific's annualized results should be adjusted by this amount in order to properly reflect the correct expense level in the startup revenue adjustment calculations.

D. Productivity Refund Accrual

In August 1989 Pacific reduced booked revenues by $28.6 million and also booked $1.4 million interest in anticipation of a customer refund arising from the 1989 labor productivity incentive plan adopted in D.87-12-067. Pacific notes that a similar $12.5 million entry was made in August 1988. Pacific states that it expects the productivity refund arising from 1989 operations to total $45.4 million, including interest.

GTEC's recorded results similarly reflect accruals of $1.000 million in July and $1.028 million in August 1989 for the anticipated sharing of productivity gains.

DRA submits that Pacific's and GTEC's accruals for anticipated productivity sharing are inappropriate because this would be a one-time refund for 1989 results which would not carry into 1990. DRA asserts that the effect of the utilities' proposed accruals would be to add the refunded money to rates beginning in 1990 on a permanent basis, essentially negating the benefits of the sharing refund in the first year and penalizing ratepayers by the same amount each year thereafter. DRA also points out that

D.89-10-031 recognizes that sharing under the new incentive framework should not affect future years' results:

> "We note that a ratemaking adjustment may be required in a year in which a prior year's excess earnings are returned to ratepayers through the sharing mechanism, to prevent the return of earnings from depressing current year earnings in the sharing calculation." (D.89-10-031, p. 287.)

DRA submits that this principle should also apply to the startup calculation and that Pacific's and GTEC's recorded results should be adjusted to remove effects of the sharing accrual. Since Pacific's accrual occurs only in August, no adjustment to Pacific's results would be needed if results from only the first seven months of 1989 were used, as DRA recommends.

Pacific responds that if there is no adjustment in 1989 results for revenues to be returned to ratepayers under the existing labor productivity sharing mechanism, the result would be to permanently capture the labor productivity achievement via a permanent rate reduction, a concept the Commission rejected in the new framework in D.89-10-031. Pacific submits that the same principle should apply to the startup calculation. Pacific submits that the D.89-10-031 language DRA cites refers to reflecting a prior year's sharable earnings in a current year's results, and that Pacific has reflected only 1989 sharable productivity gains in 1989. Pacific concludes that its productivity adjustment is fully consistent with D.89-10-031. GTEC joins Pacific in opposing DRA's position on this matter.

We agree with Pacific that under the new regulatory framework commencing in 1990 sharable earnings will not be captured as permanent rate reductions. However, there are several reasons why inclusion of productivity accruals in 1989 annualized results would be improper. First, Pacific's and GTEC's productivity accruals run counter to the provision that reviews should be adjusted by an amount needed to yield the market-based rate of return. For 1989, Pacific expects that it will pay a refund to ratepayers under the labor productivity sharing mechanism. No such productivity refund will be paid in any subsequent year, since this particular mechanism ends with the start of the new regulatory framework. To permit this accrual would be in effect to forecast that Pacific would pay a $45.4 million refund in each subsequent year, when in fact it will not. Therefore, the effect would be to set rates to yield the market-based rate of return plus $45.4 million. Further, since the labor productivity refund mechanism for 1989 was developed within the traditional regulatory framework, a subsequent general rate case would indeed have captured the productivity improvements for ratepayers. Finally, since Pacific's and GTEC's productivity accruals are based on mid-year estimates of year-long labor savings, we have no way of verifying their accuracy.

While we recognize that capture of productivity savings for ratepayers is one of the criticisms levied at traditional rate of return regulation, the fact remains that that was the framework within which the 1989 labor productivity sharing mechanism was adopted. We find it proper to treat the 1989 productivity results within the context of the traditional regulatory framework since the incentive-based framework is in effect only after January 1, 1990. As a result, the annualized results of Pacific's and GTEC's productivity accruals ($45.4 million and $3 million, respectively) should be removed from 1989 results used as the basis for the startup revenue adjustments.

E. Treatment of Intrastate Settlements

The proper treatment of intrastate settlements revenue transfers in the startup revenue adjustment was one of the most contentious issues surfacing in the compliance filings.

Controversies arose largely because GTEC and Pacific use different methods for booking settlements revenues in the monthly results of operations reports submitted to the Commission which form the basis of the compliance filings. In its monthly reports, GTEC uses normalized settlements revenues (estimated settlements for each month not including later true-ups or out-of-period settlements). On the other hand, Pacific books all settlements in the month that the claims are recognized, including claims pertaining to prior months' or years' operations (out-of-period adjustments). Because of this difference, Pacific's compliance filing reflects \$267.548 million in settlements payments to GTEC on an annualized basis whereas GTEC's filing reflects receipt of \$195.288 million.

DRA believes a consistent method of reflecting settlements revenues should be used for both utilities in determining the startup revenue adjustment and recommends use of actual recorded settlements revenues, including out-of-period adjustments. GTEC contends inclusion of such nonrecurring settlement revenues would be contrary to the guiding principle that the startup revenue adjustment should result in 1990 rates "reasonably expected to produce earnings equal to the market-based rate of return" (D.89-10-031, p. 297), since it believes this approach would overstate its 1990 revenues. On the other hand, Pacific argues that it is appropriate to recognize out-of-period adjustments since the pooling process historically has been subject to true up as more current data becomes available.

In late November, GTEC and Pacific agreed that as of January 1, 1990 their intercompany intraLATA toll settlements should be based on a fixed annual payment, with the 1990 payment to be equal to the annualized 1989 settlement amount included in GTEC's compliance filing in this proceeding. As a result, in its December 1 final comments Pacific now proposes an \$84.01 million Z factor adjustment to reflect the new settlements agreement for 1990. Pacific notes that no similar Z factor adjustment would be needed for GTEC since GTEC's proposed startup adjustment already reflects the level agreed to for 1990. Pacific submits, however, that if GTEC's settlement results for 1989 are changed to a different value GTEC would also require a Z factor adjustment to reflect the agreed upon 1990 settlement payment level.

Discussion

As Pacific implies in its December 1 final comments, we need not reconcile differences between Pacific's and GTEC's booked 1989 settlements. Rather, we need only adjust each utility's reported 1989 results by the difference between its booked 1989 settlements amount and the expected 1990 settlements levels (all on an annualized basis). This adjustment essentially replaces the 1989 booked amount (however accurate or inaccurate it may be) with the 1990 expected amount in calculating revenue adjustments needed to yield an 11.5% rate of return in 1990.

This issue appears to have engendered so much controversy because D.89-10-031 discussed a two-step process for obtaining the startup revenue adjustment: in the first step, 1989 annualized revenues are adjusted to a level that would have yielded an 11.5% rate of return in 1989; the second step reflects expected 1990 cost changes through application of the price cap indexing mechanism including adjustments for any exogenous (Z) factors which change costs between 1989 and 1990. Following that two-step process, a consistent 1989 settlements amount would be established for the two utilities and a Z factor adjustment would then be applied to reflect any settlements changes between 1989 and 1990. However, the same net result can be obtained by a single adjustment for each utility to reflect the difference between the 1989 settlements amount included in its compliance filing and the 1990 settlements amount.[1] Because of this, there is no need to determine the proper 1989 settlements amount between Pacific and GTEC. As a result there is no need to pass judgment on the appropriateness of Pacific's $11.75 million adjustment to reflect previously understated settlement effects of the USOA rewrite authorized by D.88-09-030. Similarly, there is no need to determine whether the $38.5 million revenue reduction Pacific booked in August 1989 to reflect increased out-of-period settlement claims by GTEC is appropriate.

Pacific and GTEC state that they have reached agreement regarding a $195 million settlements payment for 1990, though no contract has been finalized. DRA asks that it and other parties be granted time to review and comment on the 1990 settlements agreement. Historically this Commission has not approved or disapproved settlements agreements among California utilities.

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1 This conclusion might be best explained by an illustration. Applying the two-step process, if we found that the proper 1989 settlements between Pacific and GTEC is $225 million, as the first step Pacific's 1989 revenues would require a downward $43 million adjustment and GTEC's 1989 revenues would increase $30 million relative to the amounts included in their compliance filing. (268 - 43 = 225 and 195 + 30 = 225.) If we further found that the proper 1990 settlements is $200 million, the second step would employ a Z factor adjustment of $25 million (a decrease for Pacific and an increase for GTEC) to update the $225 million 1989 level to reflect the 1990 settlement change. The net effect of the two steps would be a $68 million reduction (43 + 25) for Pacific and a $5 million increase (30 - 25) for GTEC.

The two steps can be combined into a single adjustment equal to the difference between the amount included in the compliance filing and the 1990 settlements amount. This adjustment would be a $68 million (268 - 200) decrease for Pacific and a $5 million increase (200 - 195) for GTEC. Under this approach, the same net result is reached and the "proper" 1989 amount is not needed at all.

However, parties may review the settlements agreement between Pacific and GTEC as part of the settlements workshop which will be held as part of Phase III of this proceeding[2] to explore alternatives to the existing settlements and intrastate high cost fund processes and may present their views in that forum regarding whether the Commission should take a more active role in review of settlements agreements.

Pending review in the Phase III workshop, we will adopt a $195.288 million estimate for 1990 settlements between Pacific and GTEC. Based on the one-step approach, we find that a net settlements adjustment of negative $72.260 million for Pacific is reasonable and that no adjustment for GTEC is required since its 1989 annualized booked settlements match the $195.288 million 1990 settlements estimate.

Pacific also included an annualized $94.236 million settlements obligation to other local exchange carriers in 1989 as part of its compliance filing and appears to imply largely by silence on the topic that 1990 payments are expected to be a comparable amount. No party challenged Pacific's estimate. As a result, we will adopt this estimate in determining Pacific's 1990 startup revenue adjustment.

Because of significant uncertainty surrounding Pacific's 1990 settlements levels, we will make both the $195.288 million settlements level adopted for GTEC and the $94.236 settlements forecast for smaller local exchange carriers subject to refund. Pacific shall report as part of its October 1, 1990 advice letter filing applying the price cap indexing mechanism for 1991 the

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2 This workshop will be held as required by the November 22, 1989 Assigned Commissioner's Ruling in this proceeding.

actual and expected total 1990 settlements, excluding out-of-period adjustments for periods prior to 1990. GTEC should similarly report on 1990 settlements received from Pacific as part of its own October 1, 1990 advice letter filing. We will determine at that time whether true-up adjustments are needed. If a simpler settlements process is implemented as a result of Phase III workshops, the need for such true-ups may be largely obviated in the future.

Parties should address in the workshops to be held in compliance with Ordering Paragraph 19 of D.89-10-031 how settlements should be treated in evaluation of whether sharable earnings exist each year under the new regulatory framework.

F. Inflation Index Minus Productivity Adjustment

In its compliance filing, Pacific submitted that application of the GNP-PI inflation index reduced by the adopted 4.5% productivity adjustment would yield a revenue adjustment of $24.61 million. While that filing was based on a GNP-PI change of 4.87%, Pacific later agreed with GTEC that this number should be rounded to 4.9% and stated that this change would increase the revenue adjustment by approximately $2 million. Using a GNP-PI inflation factor of 4.9%, GTEC calculates an inflation minus productivity adjustment of $7.752 million.

D.89-10-031 required that Pacific and GTEC propose which time period, publisher, and specific measure of GNP-PI should be used in the price cap indexing mechanism. In their compliance filings, they respond that the sole source and publisher of GNP-PI is the Bureau of Economic Analysis of the U.S. Department of Commerce.

Pacific submits that the finalized second quarter GNP-PI figure becomes available the last week in September of each year, in time for use in the advice letters to be filed on October 1 of each year to apply the price cap index mechanism to rates. Therefore, Pacific proposes that the time period over which change in GNP-PI is measured should be between the second quarter of the prior year and the second quarter of the current year. As a result, Pacific obtains the GNP-PI change by dividing the second quarter 1989 GNP-PI by the second quarter 1988 GNP-PI.

GTEC takes a similar approach, using GNP-PI data from the Survey of Current Business, Vol. 69, No. 8, published by the U.S. Department of Commerce, Bureau of Labor Statistics (August, 1989). While the underlying GNP-PI data relied upon by Pacific and GTEC are identical, GTEC rounds the GNP-PI change to 4.9%.

DRA submits that the method used by Pacific and GTEC for calculating the inflation component (taking the percentage change between the second quarter 1988 and the second quarter 1989 values) is inappropriate. DRA proposes instead that the GNP-PI measure should be what it calls an "annual average," obtained by comparing inflation indices in quarters three and four of last year and quarters one and two of this year with inflation indices in the same quarters for the prior years. According to DRA, GTEC witness Schankerman provided examples in his prepared Phase II testimony which used annual average inflation indices; DRA also asserts that the current attrition procedures compare annual averages for calculating nonlabor inflation factors. DRA contends that use of annual average changes would promote rate stability as rates would be less susceptible to transitory inflation effects, either up or down, than if average quarterly changes are used.

GTEC and Pacific respond that their approach to deriving the GNP-PI inflation factor is consistent with D.89-10-031 and that DRA's is not. GTEC believes that DRA misunderstands the GNP-PI data used by GTEC and Pacific. GTEC's proposed factor of 4.9% does not reflect inflationary changes based solely on one quarter's data in 1988 versus one quarter in 1989 as DRA appears to assert, but instead reflects the cumulative change in prices between July 1, 1988 and June 30, 1989. DRA's approach, on the other hand, includes data from the third and fourth quarters of 1987 in calculation of the inflation factor for 1990, which runs counter to the intent stated in D.89-10-031 that use of historical inflation data creates a delay of only 6 to 18 months. GTEC concludes that the decision clearly does not contemplate use of such obsolete data. GTEC also disputes DRA's claims regarding the type of inflation data presented by Schankerman.

Pacific agrees with GTEC's arguments, and submits further that the GNP-PI is relatively stable because it covers a broad section of goods and services and that as a result there is no need to do any further averaging in the interest of rate stability, as suggested by DRA.

Because it is uncontroverted, we conclude that GNP-PI data published by the U.S. Department of Commerce should be used in the price cap indexing mechanism.

In D.89-10-031 we tentatively adopted the percentage change in the GNP-PI between June 30 of the current year and July 1 of the prior year as the measure of inflation to be used in the price cap indexing mechanism, but allowed parties to propose alternatives as part of the compliance filings. Pacific's and GTEC's method of obtaining the GNP-PI inflation index is consistent with the adopted measure. DRA's is not, since it incorporates inflation data from eight quarters going back 2-1/2 years before the January 1 that indexed rates are updated.

In choosing the period of time over which to measure inflation, there are tradeoffs between stability of the index (enhanced by measuring over a longer period of time) and timeliness (enhanced by using the most recent data available). Since the GNP-PI is relatively stable, we agree with Pacific that these two goals are reasonably balanced by reflection of inflation occurring between June 30 of the current year and July 1 of the prior year. As a result, we affirm our finding in D.89-10-031 that changes in the GNP-PI should be measured by comparing the GNP-PI measured through the end of June of one year with the comparable GNP-PI twelve months earlier.

In its comments, AT&T noted that GTEC rounded the percentage change in GNP-PI to one digit after the decimal (4.9%) while Pacific showed two digits after the decimal (4.87%), and requested use of a standard calculation. Pacific now concurs with AT&T and submits that GTEC's approach should be used since it conforms to the standard by which the GNP-PI is published. We agree with Pacific and GTEC that the percentage change in GNP-PI used in the price cap indexing mechanism should be rounded to one digit after the decimal, consistent with the degree of accuracy in the published GNP-PI data. Since we have affirmed the measure of inflation adopted in D.89-10-031 and have determined that it should be rounded to one digit after the decimal, we adopt 4.9% as the proper measure of inflation for the pricing cap indexing adjustment to be effective January 1, 1990.

Pacific calculated its proposed price cap adjustment by application of the inflation minus productivity adjustment to its 1989 billing base (based on eight months of data annualized) prior to adjustment for the interLATA SPF-to-SLU shift. GTEC applied the index to its 1989 annualized revenues rather than to its billing base. Since for years after 1990 the price cap indexing mechanism will be applied to rates rather than revenues, we conclude that use of the billing base is more consistent with the intent of D.89-10-031 than is GTEC's method. Further, the inflation minus productivity adjustment should be applied to the 1989 annualized billing base after adjustment for 1990 interLATA SPF-to-SLU shifts. With these adjustments, we adopt inflation minus productivity adjustments equal to $26.202 million for Pacific and $7.107 million for GTEC.

G. <u>Adjustments for Exogenous Factors</u>

A portion of TURN's petition for modification of D.89-10-031 concerns whether future cost changes should be eligible for consideration as exogenous factors with recognition in the price cap indexing mechanism. D.89-10-031 provides the following guidance regarding measurement of costs of exogenous factors:

> "In keeping with the principle that recorded data should be used to the extent possible, actual costs already incurred should be relied upon if feasible to measure impacts of exogenous events. If future cost changes are known with a high degree of certainty, we would be willing to consider inclusion of such cost changes on a forecasted basis. However, if the fact that a cost change will occur during the upcoming year is known but estimates of its magnitude are speculative, we expect local exchange carriers to defer requesting that such changes be recognized in rates until their magnitude can be determined with reasonable certainty and minimal controversy."
> (D.89-10-031, p. 236.)

In its petition, TURN requests that the Commission refuse to consider future cost changes at all, in order to minimize controversy in application of the price cap indexing mechanism, or alternatively that the Commission order the local exchange carriers to true-up such forecasts at year end to remove the incentive to overstate projected cost changes.

Pacific opposes TURN's request on three grounds. First, it asserts that controversies surrounding the compliance filings have centered around whether certain items should be included, with little dispute over the actual dollar amounts projected by Pacific for those items. Second, Pacific submits that TURN inappropriately repeats arguments on the ALJ's proposed Phase II decision which the Commission has already rejected. Finally, Pacific notes that the Commission recognized that implementation of the startup revenue adjustment "may not be entirely straightforward or free of controversy" (D.89-10-031, p. 301). Pacific concludes that TURN has not demonstrated that the amount of controversy has been unacceptable nor that such controversy has affected TURN's opportunity to be heard.

We see no need to adopt either a blanket prohibition on consideration of future cost changes in the price cap indexing mechanism or a blanket requirement that forecasted cost changes be trued up later. We stressed in D.89-10-031 that speculative cost changes should not be proposed. With that limitation, we prefer to address the accuracy and reasonableness of proposed exogenous cost adjustments on a case-by-case basis. For some items, such as intercompany settlements discussed earlier, we may well determine that a true up is appropriate. Because we believe that the adopted approach provides adequately for consideration of future cost changes, this portion of TURN's petition for modification of D.89-10-031 should be denied.

1. Separations Change for Central Office Equipment and Revenue Accounting Expenses

Since the separations change reflected in rates by Resolution T-13037 was in effect for only a portion of 1989 for Pacific, as discussed in Section III.C.4, Pacific submits that there should be an incremental revenue increase of $7.52 million for 1990 to recognize the full year impact of this separations change in 1990.

DRA submits that this is actually an annualization adjustment and by its inclusion as a Z factor that Pacific proposes adjusting twice for this separations change. DRA concludes that this adjustment should be rejected together with Pacific's other proposed annualization adjustments.

Since Resolution T-13037 recognized only nine months of this mandated separations change, we conclude that this adjustment is properly a Z factor adjustment consistent with the provision in D.89-10-031 regarding treatment of separations changes. As a result, and because Pacific's 1990 adjustment of $7.52 million is consistent with the revenue levels authorized in Resolution T-13037, we adopt Pacific's 1990 adjustment as reasonable. Since GTEC reflected this separations change throughout 1989, no incremental revenue adjustment is needed for GTEC.

2. Separations Change in Apportioning Local Switching Costs Based on Dial Equipment Minutes

Pacific states that its intrastate revenue requirement will increase $10.91 million in 1990 as a result of an FCC-required phase-in of Measured Dial Equipment Minutes (DEM) as an allocator of local switching costs. GTEC proposes a comparable adjustment of $9.091 million.

DRA agrees that this adjustment should be made, but believes that GTEC's adjustment as originally submitted should be recalculated to remove an inconsistency. GTEC agrees with DRA, and now states that the correct adjustment is $11.29 million.

Since GTEC agrees with and has made the correction proposed (but not quantified) by DRA, no party disagrees with the DEM adjustments proposed by Pacific and GTEC. As a result, we find reasonable and adopt these adjustments.

3. Fire Suppression and Asbestos Survey and Removal

Pacific submits that expenses required to comply with certain fire suppression requirements imposed by the cities of Los Angeles and Pasadena and to comply with various asbestos management requirements required by California law should be reflected in its startup revenue adjustment as exogenous factors. These expenses total $10.7 million for fire suppression and $4.8 million for asbestos survey and removal.

DRA, TURN, AT&T, MCI, and CCTA oppose these adjustments on the primary basis that these costs are normal costs of doing business which are adequately reflected in the GNP-PI. TURN submits that Pacific is not disproportionately affected by these requirements. MCI asserts that the cited costs are loose estimates. Pacific argues that these are not normal business costs and are not reflected in the GNP-PI since they result from local requirements.

GTEC notes that it too will incur expenses due to these code requirements, but that it does not propose that they be treated as exogenous factors.

In order for building code and similar requirements to qualify for treatment as exogenous factors, Pacific would have to establish that their costs are significantly higher than costs of similar (not necessarily identical) restrictions elsewhere in the nation. Certainly fire and asbestos protection are national issues and various jurisdictions have imposed restrictions in other localities. We find that Pacific has not met its burden of showing that these costs qualify for treatment as exogenous factors within the guidelines established in D.89-10-031. As a result, we deny Pacific's request.

4. <u>USOAR Turnaround</u>

D.88-09-030 provided for annual USOA rewrite (USOAR) turnaround adjustments because USOAR capital to expense shifts will result in yearly revenue requirement reductions. While initially a revenue requirement increase (of $123 million for Pacific) resulted from the USOA rewrite, the Commission recognized that ratepayers should realize the benefit of reduced revenue requirement impacts that will occur in future years and required that:

> "Each utility shall file the reduced revenue requirement impacts from the adopted USOA in its annual attrition filing, until its next rate case proceeding. Absent an attrition filing, the utility shall submit, on or before October 1 of each year, an annual advice letter to reflect its reduced revenue requirement needs." (D.88-09-030, Ordering Paragraph 3.)

GTEC proposes a negative $11.527 million revenue requirement adjustment for 1990 to reflect the USOAR turnaround.

Pacific did not propose a USOAR turnaround amount for 1990 and did not file an October 1 advice letter as required by

D.88-09-030. Pacific's position is that use of the 1989 actual rate base for calculation of its startup revenue requirement automatically reflects rate base impacts of capital to expense shifts in 1988 and 1989. Pacific also asserts that the impact of the capitalization rule changes for 1990 is inherently accounted for in the startup revenue adjustment and that a Z factor adjustment such as GTEC proposes would double count the effect of the capitalization rule change.

GTEC responds that it agrees conceptually with Pacific that a USOAR turnaround adjustment is inappropriate if the startup revenue adjustment is based on 1989 rate base and that it had reflected the USOAR turnaround because it thought that was the intent of D.89-10-031.

DRA disagrees with Pacific and GTEC, stating that startup revenue requirements will be set too high if an adjustment for USOAR is not made since the utilities' rate base will continue to decline as a result of the USOA rewrite.

While DRA agrees with GTEC's 1990 USOAR turnaround estimate, which is based on GTEC's 1989 USOAR adjustment, and originally proposed a comparable $23.433 million adjustment for Pacific, in its December 1, 1989 filing DRA now proposes a $111 million USOAR decrease for Pacific. According to DRA, this reflects the USOAR revenue increases Pacific has received to date as well as the present value of future cash flows attributable to capital to expense shifts over a 20-year life cycle.

The USOA accounting changes leading to the turnaround adjustments are exactly the type of regulatory changes which we contemplated when allowing for recognition of exogenous factors in the price cap indexing mechanism. Further, the Commission previously recognized that there would be yearly revenue requirement reductions arising from the USOAR and provided that ratepayers should receive the benefits of those cost reductions through yearly revenue adjustments. Contrary to Pacific's and

GTEC's assertions, basing the startup revenue adjustment on 1989 recorded rate base in no way captures the fact that due to the USOAR 1990 rate base will be lower than 1989 rate base. Consistent with the finding in D.88-09-030 that the USOA capital to expense shift will result in a yearly revenue requirement reduction and the conclusion that ratepayers should realize the benefit of reduced revenue requirement impacts that will occur in future years, we conclude that USOAR turnaround adjustments should continue under the new regulatory framework through recognition as exogenous factors.

Upon questioning at the November 28, 1989 workshop, Pacific staff estimated that the 1990 USOAR turnaround effects would be between $19 million and $21 million. We adopt a USOAR turnaround adjustment for Pacific of $21 million since this estimate is more consistent with 1990 effects previously provided by Pacific in the USOA rewrite proceeding. Since it was uncontroverted, we also adopt GTEC's USOAR turnaround estimate of $11.527 million.

5. Direct Assignment of WATS

The adjustment for the direct assignment of WATS reflects a change in separations procedures for WATS services ordered in D.85-06-115 and D.87-12-067.

The revenue requirement adjustments associated with this item are summarized below:

	GTEC	Pacific
1987-89 correction	$(445,000)	$(1,068,000)
Ongoing adjustment	(148,000)	(356,000)
Total	(593,000)	(1,424,000)

GTEC includes its direct assignment of WATS adjustment as an exogenous factor in the price cap indexing mechanism. Pacific takes the position that this adjustment should be incorporated as part of its intraLATA SPF-to-SLU adjustment because the revenue decrease should be applied to the exchange services category only.

DRA agrees with GTEC's and Pacific's estimates of this adjustment. Since these estimates include a one-year error adjustment for the years 1987 through 1989, DRA recommends that only the revenue impacts for 1990 be reflected in the surcharge adjustment mechanism for the exchange service category. DRA recommends that the 1987 through 1989 revised incremental settlement impacts be included in the startup revenue adjustment.

Since all parties agree on these adjustments, we find them reasonable. Consistent with prior decisions, we will continue to apply direct assignment of WATS adjustments, including the corrections factor, to exchange services only. The incremental surcredits reflecting the one-time adjustments are to be removed at the end of 1990.

We note that Pacific's compliance filing shows its existing one-time surcredit as part of the starting surcredit. We will reflect GTEC's direct assignment of WATS adjustment and the incremental portion of Pacific's adjustment as exogenous factors, but will apply the resulting surcredits to exchange services only.

6. Tax Benefits from Premature Bond Retirement

CACD conducted a workshop earlier this year pursuant to D.88-12-094 to determine the method for returning to ratepayers certain tax benefits which have resulted from Pacific's and GTEC's premature retirement of high coupon bonds. Pacific, GTEC, and DRA all agree on the amount of the adjustments for 1990, which are included in a workshop report prepared by CACD. DRA and GTEC also filed a joint motion dated May 10, 1989 with a proposed resolution of this issue.

DRA proposes that the startup revenue adjustments reflect agreed-upon tax benefits resulting from the premature retirements. Pacific notes that this adjustment is not the result of Commission action but states that it is not opposed to this adjustment as a Z factor in order to avoid the necessity of future Commission action. GTEC believes that its omission of this adjustment is consistent with D.89-10-031 and points out that it made no adjustments in its compliance filing in either direction based on the anticipated outcome of pending Commission proceedings.

Consistent with our treatment of Pacific's proposed adjustments for compensated absences and the $200 to $500 expense limit increase, we will not reflect tax benefits due to premature bond retirements in the startup revenue adjustment because we have not yet reviewed and approved the proposed adjustment.

7. Depreciation Represcription and Technical Updates

DRA believes that Pacific and GTEC should update their depreciation expense for 1990 through either a Z factor adjustment or as part of the initial 1989 adjustments, on the basis that such updates are normally made in attrition adjustments. DRA states that Pacific is due for a technical update of its depreciation expenses and that GTEC is due for a represcription,[3] and estimates the adjustments to be a $45 million decrease for Pacific and a $3 million increase for GTEC. Pacific and GTEC oppose these adjustments.

We agree with Pacific that it would be inappropriate to reflect DRA's proposed 1990 depreciation updates as part of the 1989 adjustment since recorded 1989 results reflect current approved depreciation rates for 1989. Inclusion as a Z factor adjustment would also be improper, since D.89-10-031 provided that:

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3 In depreciation represcriptions, plant accounts, depreciation rates, future net salvage values, retirement patterns, and growth of telephone plant are evaluated. Represcriptions are done every second year for GTEC and every third year for Pacific, with simpler technical updates in intervening years.

> "Contrary to DRA's position, since utility investments and plant lives are to a large extent within management's control, we believe that most, if not all, depreciation changes are not exogenous factors and thus should not be reflected in rates through the Z factor. However, if any extraordinary depreciation change occurs due to arguably exogenous events, parties may propose that its effects be recognized in the indexing mechanism through the Z factor." (D.89-10-031, p. 183.)

Since DRA has not made any claim that the depreciation updates would be due to extraordinary changes arising from exogenous events, it would not be appropriate to reflect them in the price cap indexing mechanism as an exogenous factor. DRA's request is denied.

8. <u>Interstate Universal Service Fund Change</u>

AT&T and MCI assert that GTEC's revenues should be adjusted to reflect any changes in payments that GTEC receives from the interstate Universal Service Fund in 1990. AT&T believes Universal Service Fund funding changes should be reflected as annual Z factor adjustments for GTEC because they are the result of FCC-ordered separations rule changes which D.89-10-031 permits to be included in Z factor adjustments.

GTEC states that it did not reflect this item in its 1990 price cap index because it did not consider the adjustment (a 1990 reduction of $1.973 million in Universal Service Fund revenues) to be of sufficient magnitude to warrant consideration as an exogenous factor.

We agree with AT&T and MCI that Universal Service Fund funding changes should be recognized as an exogenous factor in the price cap indexing mechanism since they result from separations rule changes. Because of this, we adopt GTEC's $1.973 million estimate for reflection in the startup revenue adjustment.

H. Switch Replacement Expense

Pacific makes a further revenue adjustment to reflect the $11 million in expenses related to switch replacement authorized by D.89-10-031. No party objects to this adjustment. We agree that this adjustment is appropriate since it was explicitly authorized by D.89-10-031.

I. Summary of Startup Revenue Adjustment

The total startup revenue adjustments for Pacific and GTEC resulting from our resolution of the above issues are shown in Table 1 and Table 2. For the reasons discussed above, we adopt a startup revenue decrease of $390,554,000 for Pacific and a startup revenue increase of $32,224,000 for GTEC, to be effective on January 1, 1990. Calculation of the appropriate billing surcharges and surcredits is discussed in Section VI.

IV. SPF-to-SLU Effects

Pacific and GTEC propose to reflect the following 1990 intraLATA and interLATA SPF-to-SLU shifts:

	Pacific	GTEC
InterLATA SPF-to-SLU:		
Local Exchange	$ 54,590,000	$ 10,835,000
IntraLATA Toll	38,921,000	11,992,000
Intrastate Access	(93,511,000)	(22,827,000)
IntraLATA SPF-to-SLU:		
Local Exchange	8,309,000	5,224,000

Pacific and GTEC state that these amounts are calculated in compliance with SPF-to-SLU requirements established in D.85-06-115, D.87-11-022, D.87-07-022, and D.87-12-067 as modified by D.88-02-046. We adopt the SPF-to-SLU adjustments proposed by Pacific and GTEC, since no party took issue with them. The corresponding reductions in Carrier Common Line Charges (CCLCs) as reflected in the interLATA SPF-to-SLU sections of Pacific's and GTEC's compliance filings are reasonable and are adopted. Calculation of appropriate billing surcharges and surcredits is discussed in Section VI.

V. Funding of Bargained VEBA Trust

Pacific reports that the Financial Accounting Standard Board (FASB) has proposed that companies be required to accrue the costs of post-retirement health and welfare benefits when the liability is incurred. These costs are currently accrued on a pay-as-you-go basis.

While FASB proposes that this change become effective January 1, 1992 if adopted, Pacific asks that rates be authorized at this time to begin funding post-retirement health benefits for union-represented employees through a Bargained Voluntary Employee Beneficiary Association (VEBA) trust. Since contributions to a Bargained VEBA trust and earnings on trust assets would be tax deductible and the benefits can be provided to retirees tax-free, such a trust can reduce the net cost of providing these benefits. If allowed for ratemaking, funding of these benefits through a Bargained VEBA trust would also allow the tax advantages to flow through to ratepayers. Pacific states that even if FASB does not approve the proposed accounting change for post-retirement health and welfare benefits, the Bargained VEBA trust can be wound down by using the funds to pay benefits, or it can continue to be used to fund retiree benefits and generate additional tax benefits. In either case, previously realized tax advantages would be preserved.

Pacific states that under provisions of its pending labor contracts, approximately $150 million per year could be contributed to a Bargained VEBA trust, or approximately $115 million on an intrastate basis. Pacific submits that by optimizing the tax advantages which are available now, Pacific can ensure that ratepayers begin to realize the full advantage of these cost reductions as soon as practicable.

DRA believes that Pacific's proposal is premature since the FASB change if adopted would not be effective until calendar year 1992. Since this is likely to be highly controversial, DRA submits that it is more appropriate to wait to see FASB's final statement rather than overreact to an exposure draft. DRA also asserts that Pacific's filing lacks quantitative support of claimed tax benefits which would be required before ratemaking can be performed with confidence.

Pacific's proposal that we approve contributions to a Bargained VEBA trust absent and prior to adoption of such a requirement by FASB does not fall within the scope of the compliance filings authorized by D.89-10-031: it is not an adjustment to 1989 results and, since FASB has not mandated this change, does not meet the criteria for characterization as an exogenous factor necessary to warrant inclusion in the 1990 price cap indexing mechanism. Indeed, Pacific makes no attempt to even argue that such is the case and does not include the purported revenue requirements associated with a Bargained VEBA trust in its requested rate adjustment. Because of this, we find no basis for consideration of this request at this time.

VI. Surcharges/Surcredits for Adopted Revenue Adjustments

Several issues were raised regarding calculation of surcharges and surcredits to reflect the startup revenue adjustments.

GTEC requests that the Commission modify D.89-10-031 to permit it to place any revenue increases resulting from the startup revenue adjustment in a memorandum account rather than reflect the change in an adjustment to its billing surcharges/surcredits effective January 1, 1990. GTEC believes that its customers would be better served if the additional revenues are recorded to a memorandum account until (1) new discrete rates are established in the upcoming supplemental rate design phase of this proceeding, or (2) until application of the price cap index for 1991 in the event rates adopted in the supplemental rate design proceeding have not been fully implemented prior to that time. GTEC asserts that use of a memorandum account would be reasonable because other revenue changes, such as a labor productivity refund, are likely to occur in early 1990. GTEC submits that this approach would minimize the number of surcharge/surcredit changes that would otherwise occur prior to a decision in the supplemental rate design proceeding.

GTEC states, however, that it will adjust its current billing surcharges/surcredits to reflect 1990 impacts of the interLATA and intraLATA SPF-to-SLU shifts mandated by D.85-06-115 and D.87-12-067.

We find that accumulation of GTEC's authorized revenue increase (excluding direct assignment of WATS effects since they apply to exchange services only) in a memorandum account is reasonable, as GTEC proposes, because this approach would allow a single net revenue adjustment later in 1990. GTEC's petition for modification of D.89-10-031 should be granted.

BAT takes exception to the manner in which Pacific calculates surcredits associated with its proposed startup revenue adjustment. BAT notes that Pacific has excluded flexibly priced services from application of the surcredit associated with the price cap portion of the revenue adjustment. BAT believes that Pacific's approach is inconsistent with the direction that "the startup revenue adjustment should be implemented as a uniform surcharge/surcredit to all intrastate access, intraLATA toll, and exchange services, consistent with existing Commission practice" (D.89-10-031, p. 301). Pacific rejoins that the adopted price cap indexing mechanism clearly applies only to rate caps for flexibly priced services and not to flexibly priced rates.

While, as Pacific points out, D.89-10-031 provides that only rate caps and not rates for flexibly priced services be updated on an annual basis, BAT is correct that the decision provides for transition treatment of the startup revenue adjustment, with application on a uniform surcharge/surcredit basis to all services including flexibly priced services until after the supplemental rate design proceeding. The surcharges and surcredits adopted in this decision reflect such treatment.

Pacific submits that the adjustment it proposes to reflect the new settlements arrangement between Pacific and GTEC effective January 1, 1990 should be reflected in the surcharge/ surcredit applicable only to toll rates. In Pacific's view, since this adjustment relates only to intraLATA toll settlements it should be handled in a manner consistent with treatment of toll settlement effects resulting from intraLATA SPF-to-SLU, which recognizes that toll settlements are directly related to toll services. Since Pacific's proposal is contrary to D.89-10-031 which provides that the startup revenue adjustment shall be applied uniformly to all services, it will not be adopted. The only exception to this uniform applicability requirement arises in the adjustment for direct assignment of WATS, as previously discussed, based on the methodology adopted in prior decisions.

No party took issue with the 1989 annualized billing bases, adjusted for 1990 interLATA SPF-to-SLU shifts, which were presented by Pacific and GTEC as the basis for surcharge/surcredit calculations. Consistent with our conclusions regarding treatment of flexibly priced services, 1990 settlements adjustments, and direct assignment of WATS adjustments, the surcredits and surcharges required to implement the revenue adjustments adopted in this decision are as follow:

Pacific

	Exchange	Toll	Access
Surcharge effective 12/31/89	-4.611%	-3.375%	-14.470%
AT&T billing & collection*	-0.641	-0.641	- 0.641
STARTING SURCHARGE	-5.252	-4.016	-15.111
Startup surcharge adjustment	-5.968	-5.957	- 5.957
InterLATA SPF-to-SLU shift	1.678	1.678	- 1.550
IntraLATA SPF-to-SLU shift	-0.255	-	-
TOTAL COMPLIANCE FILING ADJUSTMENT	-4.545	-4.279	- 7.507
TOTAL SURCHARGE 1/1/90	-9.797	-8.295	-22.618
One-time refunds to end 12/31/90:			
1987-89 direct assignment of WATS	-0.033		
AT&T billing & collection*	-0.641	-0.641	- 0.641
TOTAL SURCHARGE 1/1/91	-9.123	-7.654	-21.977

*Effect of Advice Letter No. 15611A.

GTEC

	Exchange	Toll	Access
Surcharge effective 12/31/89	-18.51%	-2.49%	2.48%
Direct assignment of WATS	- 0.08	-	-
InterLATA SPF-to-SLU shift	1.47	1.47	-1.72
IntraLATA SPF-to-SLU shift	- 0.71	-	-
TOTAL SURCHARGE FILING ADJUSTMENT	0.68	1.47	-1.72
TOTAL SURCHARGE 1/1/90	-17.83	-1.02	0.76
One-time refund to end 12/31/90:			
1987-89 direct assignment of WATS	-0.06		
TOTAL SURCHARGE 1/1/91	-17.77	-1.02	0.76

Consistent with our granting GTEC's motion, GTEC is authorized to record an annual revenue increase of $32.817 million (the $32.224 million net startup revenue adjustment excluding negative direct assignment of WATS effects reflected in the above surcharges/surcredits) in a memorandum account pending further Commission action.

We note that on November 22, 1989 AT&T filed Advice Letter No. 156 to reduce rates for its intrastate services to reflect lower access charges anticipated as a result of a Commission decision authorizing startup revenue adjustments for Pacific and GTEC. Consistent with the discussion in that advice letter, we expect AT&T to supplement Advice Letter No. 156 to reflect the effects of today's decision.

Findings of Fact

1. In D.89-10-031 Pacific and GTEC were ordered to make compliance filings in I.87-11-033 providing information to allow a startup revenue adjustment effective January 1, 1990 so that 1990 rates are reasonably expected to produce earnings equal to an 11.5% market-based rate of return.

2. D.89-10-031 provided that Pacific and GTEC should include the surcredit/surcharge effects of previously authorized interLATA and intraLATA SPF-to-SLU shifts in their compliance filings, rather than making separate advice letter filings as previously authorized for this purpose.

3. Pacific's compliance filing showed materially different results for August 1989 than for prior months in 1989.

4. In a supplemental filing Pacific identified several items which account for most of the variance in August results.

5. DRA filed a petition for modification of D.89-10-031 in which it requests that startup revenue adjustments be based on either the first six months of recorded data for 1989 or in the alternative on the first seven months of recorded data if it appears appropriate.

6. TURN filed a petition for modification of D.89-10-031 in which it requests, among other things, that startup revenue adjustments be based on only the first six months of recorded data for 1989 and that either (a) future cost changes not be considered as exogenous events in the price cap indexing mechanism or (b) forecasts of such future cost changes be trued up at year end.

7. Pacific submits that if its first eight months' actual results for 1989 were restated to reflect revenue impacts of productivity sharing and GTEC settlements in the months in which they apply rather than in August, the August rate of return would rise to 12.16%.

8. Pacific's reported August 1989 results, taking into account the identified adjustments, are not out of line with results for earlier months.

9. As a general principle, reliance on results for both GTEC and Pacific from as much of 1989 as possible should yield increased accuracy in startup revenue adjustments.

10. It is reasonable to base Pacific's and GTEC's startup revenue adjustments on recorded results from the first eight months of 1989 since Pacific's August 1989 results, taking into account the identified adjustments, are not out of line with results for earlier months and reliance on results from as much of 1989 as possible should yield increased accuracy.

11. TURN asks that rate base figures from the most recent month recorded rather than average rate base for the first eight months of 1989 be used as an estimate of the average 1989 rate base, since Pacific's rate base is declining.

12. To open up the compliance filings for consideration of which ongoing cost changes are likely to increase and which are likely to decrease net earnings in the last four months of 1989 would run counter to the intent in D.89-10-031 that startup revenue adjustment issues be resolved in a timely fashion so that the new regulatory framework can be implemented on January 1, 1990.

13. Because consideration of such issues could prevent timely implementation of the new regulatory framework, it is reasonable to deny TURN's request that a rate base estimate different than that allowed by D.89-10-031 be considered.

14. No party questions the numerical accuracy of calculations Pacific and GTEC performed to adjust annualized eight months'

recorded results to yield an 11.5% rate of return. As a result, it is reasonable to use Pacific's and GTEC's results in determining startup revenue adjustments.

15. D.88-09-030 requires that Pacific file an advice letter for recovery of its compensated employee absences impact.

16. Resolution F-626 requires that Pacific and other telephone companies file applications if they seek revenue requirement increases due to intrastate adoption of the FCC's Part 32 USOA expense limit change.

17. It would be premature to reflect Pacific's estimates of costs of compensated employee absences and the $200 to $500 expense limit increase in rates before the Commission has reviewed these issues.

18. It is reasonable to remove both accrued revenues and booked expenses associated with compensated employee absences and the $200 to $500 expense limit increase from 1989 results used as the basis for startup revenue adjustments.

19. D.89-10-031 provided that rate or revenue impacts approved in a Commission resolution or decision may be reflected in the startup revenue adjustments in the manner previously recognized in annual attrition adjustments.

20. Resolution T-13073 required that Pacific flow through to its ratepayers the $22 million incremental 1989 revenue requirement effects of its new billing and collection contract with AT&T, commencing January 1, 1990.

21. Since Pacific began booking monthly effects of the AT&T billing and collection refund in July 1989, eight months' annualized results reflect only an $11 million revenue reduction for the AT&T billing and collection refund.

22. Since the $22 million AT&T billing and collection refund is a known effect of a prior Commission resolution, its recognition in Pacific's startup revenue adjustment is reasonable.

23. Resolution T-13037 bases Pacific's 1989 attrition adjustment on its labor contract in effect in December 1988.

24. Since Pacific's new labor agreements have not been approved in a Commission resolution or decision, it is reasonable to not reflect them in Pacific's startup revenue adjustment.

25. Pacific estimates that the Commission-authorized repricing of its intraLATA 800 service results in a 1989 revenue loss of $5.7 million, but that the total revenue loss including potential customer loss if the repricing had not occurred is $31.2 million.

26. Since only $5.7 million of Pacific's estimated revenue loss from Pacific's intraLATA 800 service is expected to occur due to regulatory action, it is reasonable to reflect only this revenue loss through the startup revenue adjustment, consistent with the intent of D.89-10-031 to consider only rate or revenue impacts arising directly from regulatory action. The appropriate adjustments to 1989 annualized results are $2.85 million for Pacific and $520,000 for GTEC.

27. Since Resolution T-13037 authorized revenue recovery of effects of a separations change for central office equipment and revenue accounting expenses which was effective on April 1, 1989 for Pacific, it is reasonable to adjust Pacific's annualized results to reflect the entire authorized 1989 expense level.

28. Pacific's and GTEC's productivity accruals run counter to the provision in D.89-10-031 that rates should be adjusted by an amount needed to yield the market-based rate of return since their effect would be to set rates to yield the market-based rate of return plus $45.4 million (for Pacific) or plus $3 million (for GTEC).

29. The 1989 productivity sharing mechanisms for Pacific and GTEC were adopted within the traditional regulatory framework, which captures productivity savings for ratepayers through general rate cases.

30. Pacific's compliance filing reflects $267.548 million in settlements payments to GTEC on an annualized basis whereas GTEC's filing reflects receipt of $195.288 million.

31. In late November 1989, GTEC and Pacific agreed that as of January 1, 1990 their intercompany intraLATA toll settlements should be based on an fixed annual payment, with the 1990 payment to equal the amount shown in GTEC's compliance filing.

32. Regarding settlements, the same result as that obtained by the two-step process described in D.89-10-031 can be reached by a single adjustment for each utility to reflect the difference between 1989 settlements included in its compliance filing and actual 1990 settlements, with no need to determine the proper 1989 settlements amount between Pacific and GTEC.

33. Because of the fact described in Finding of Fact 32, there is no need to determine the proper 1989 settlements amount between Pacific and GTEC, the appropriateness of Pacific's $11.75 million adjustment to reflect previously understated settlement effects of the USOA rewrite, or the appropriateness of the $38.5 million revenue reduction Pacific booked in August 1989.

34. Consistent with prior Commission practice of reflecting settlements agreements in rates, it is reasonable to adopt a $195.288 million estimate for 1990 settlements between Pacific and GTEC pending review in a Phase III workshop and possible true-up since Pacific and GTEC state that they have reached agreement on this amount.

35. Pacific included an annualized $94.236 million settlements obligation to other local exchange carriers in 1989 as part of its compliance filing but did not indicate whether 1990 payments are expected to be a comparable amount.

36. Since no party challenged Pacific's estimate of its settlements obligation to local exchange carriers other than GTEC, it is reasonable to adopt this estimate, subject to later true-up, for use in determining Pacific's 1990 startup revenue adjustment.

37. Because of significant uncertainty surrounding Pacific's 1990 settlements levels, it is reasonable to make both the $195.288 million settlements level adopted for GTEC and the $94.236 million settlements forecast for smaller local exchange carriers subject to refund with later true-ups if needed.

38. Pacific and GTEC use the percentage change between second quarter 1988 and second quarter 1989 GNP-PI as the inflation component of the price cap indexing mechanism.

39. DRA proposes that the inflation measure should be an "annual average," obtained by comparing inflation indices in quarters three and four of last year and quarters one and two of this year with inflation indices in the same quarters for the prior years.

40. It is reasonable to use GNP-PI data published by the U.S. Department of Commerce in the price cap indexing mechanism, since no party disputed that this is the sole source of GNP-PI data.

41. In choosing the period of time over which to measure inflation, there are tradeoffs between stability of the index (enhanced by measuring over a longer period of time) and timeliness (enhanced by using the most recent data available).

42. The GNP-PI is relatively stable because it covers a broad section of goods and services.

43. Since the GNP-PI is relatively stable, the goals of stability and timeliness are reasonably balanced by reflection of inflation occurring between June 30 of the current year and July 1 of the prior year.

44. It is reasonable to round the percentage change in GNP-PI to one digit after the decimal, consistent with the degree of accuracy in published GNP-PI data.

45. It is reasonable to use 4.9% as the measure of inflation for the price cap indexing adjustment to be effective January 1, 1990, consistent with Findings of Fact 40, 43, and 44.

46. Since for years after 1990 the price cap indexing mechanism will be applied to rates rather than revenues, it is reasonable, for 1990, to apply the inflation minus productivity adjustment to the 1989 annualized billing base adjusted for 1990 interLATA SPF-to-SLU shifts.

47. No party disputed 1989 annualized billing base data provided by Pacific and GTEC.

48. Consistent with Findings of Fact 45, 46, and 47, 1990 inflation minus productivity adjustments equal to $26.202 million for Pacific and $7.107 million for GTEC are reasonable.

49. A prohibition on consideration of speculative exogenous factors coupled with a case-by-case review of the accuracy and reasonableness of proposed exogenous cost adjustments provides adequately for consideration of future cost changes.

50. Since Resolution T-13037 recognized only the first nine months of the separations change for central office equipment and revenue accounting expenses, treatment of the 1990 adjustment proposed by Pacific as an exogenous factor is consistent with D.89-10-031.

51. Since Pacific's proposed 1990 adjustment of $7.52 million for the separations change for central office equipment and revenue accounting expenses is properly treated as an exogenous factor and is consistent with the revenue level authorized in Resolution T-13037, its reflection in Pacific's startup revenue adjustment is reasonable.

52. Since no party disagrees with the DEM adjustments proposed by Pacific and GTEC, it is reasonable to reflect them in the startup revenue adjustments.

53. Pacific has not shown that costs of complying with fire suppression and asbestos survey and removal requirements are significantly higher than costs of similar restrictions elsewhere in the nation.

54. D.88-09-030 provided for annual USOAR turnaround adjustments because USOAR capital to expense shifts will result in yearly revenue requirement reductions.

55. D.89-10-031 provided that accounting changes adopted by this Commission should be treated as exogenous factors.

56. Basing the startup revenue adjustment on 1989 recorded rate base does not capture the fact that due to the USOA rewrite 1990 rate base will be lower than 1989 rate base.

57. Consistent with D.88-09-030 and D.89-10-031, it is reasonable to continue USOAR turnaround adjustments as exogenous factors under the new regulatory framework.

58. No party took issue with GTEC's $11.527 million estimate of 1990 USOAR turnaround effects.

59. Since it was uncontroverted, GTEC's USOAR turnaround estimate is reasonable for use in GTEC's startup revenue adjustment.

60. Pacific estimates that its 1990 USOAR turnaround effects would be between $19 million and $21 million.

61. It is reasonable to use a 1990 USOAR turnaround effect of $21 million for Pacific since it is consistent with Pacific's estimates both at the compliance workshop and in the USOA rewrite proceeding.

62. No party took issue with Pacific's and GTEC's calculations of adjustments for the direct assignment of WATS.

63. Since they are uncontroverted, it is reasonable to adopt Pacific's and GTEC's proposed adjustments for the direct assignment of WATS.

64. Consistent with prior decisions, it is reasonable to apply direct assignment of WATS adjustments including the corrections factor to exchange services only.

65. Pacific, GTEC, and DRA all agree on the amount of benefits resulting from premature retirement of high coupon bonds, which have been included in a workshop report prepared by CACD.

66. It would be premature to reflect benefits resulting from premature retirement of high coupon bonds before the Commission has reviewed this issue.

67. It would be inappropriate to reflect 1990 depreciation updates as part of a 1989 adjustment since recorded 1989 results reflect current approved depreciation rates for 1989.

68. D.89-10-031 provides that depreciation changes should not be treated as exogenous factors in the price cap indexing mechanism unless extraordinary depreciation changes occur due to exogenous events.

69. Since DRA has not made any claim that 1990 depreciation updates would be due to extraordinary changes arising from exogenous events, it would not be appropriate to reflect them in the price cap indexing mechanism as an exogenous factor.

70. It is reasonable to reflect GTEC's $1.973 million interstate Universal Service Fund funding reduction as exogenous factor in the price cap indexing mechanism, since inclusion of such separations changes is consistent with D.89-10-031.

71. For Pacific, an $11 million revenue adjustment to reflect expenses related to switch replacement is reasonable, consistent with D.89-10-031.

72. A startup revenue requirement decrease of $393,002,000 for Pacific is reasonable as the net effect of reasonable adjustments set forth in preceding Findings of Fact.

73. A startup revenue requirement increase of $32,224,000 for GTEC is reasonable as the net effect of reasonable adjustments set forth in preceding Findings of Fact.

74. Because they are uncontroverted, it is reasonable to adopt the SPF-to-SLU adjustments proposed by Pacific and GTEC.

75. Pacific's proposal regarding contributions to a Bargained VEBA trust absent to and prior to adoption of such a requirement by FASB does not fall within the scope of the compliance filings authorized by D.89-10-031, since it is not an adjustment to 1989

results and, because FASB has not mandated this change, does not meet the criteria for treatment as an exogenous factor.

76. GTEC filed a petition for modification of D.89-10-031 in which it requests that any revenue increases from its startup revenue adjustment be placed in a memorandum account rather than reflected in adjustments to its billing surcharges/surcredits effective January 1, 1990.

77. Accrual of GTEC's startup revenue adjustment (excluding direct assignment of WATS effects) in a memorandum account is reasonable because it would allow a single net revenue adjustment later in 1990.

78. D.89-10-031 provides that the startup revenue adjustments should be implemented as a uniform surcharge/surcredit to all intrastate access, intraLATA toll, and exchange services, consistent with existing practice.

79. The surcharges and surcredits to implement the adopted revenue adjustments which are set forth in Section VI of this decision are reasonable, consistent with prior Findings of Fact.

Conclusions of Law

1. Because it is reasonable to base Pacific's and GTEC's startup revenue adjustments on recorded results from the first eight months of 1989, DRA's petition for modification of D.89-10-031 and the portion of TURN's petition for modification of D.89-10-031 addressing this issue should be denied.

2. The compliance filings should not be opened up for consideration of which ongoing cost changes are likely to increase and which are likely to decrease net earnings in the last four months of 1989, since to do so would run counter to the intent in D.89-10-031 that startup revenue adjustment issues be resolved in a timely fashion so that the new regulatory framework can be implemented by January 1, 1990.

3. Since no party questions their numerical accuracy, Pacific's and GTEC's calculations of revenue adjustments to

annualized eight months' recorded results to yield 11.5% should be used in determining startup revenue adjustments.

4. Impacts of compensated employee absences and the $200 to $500 expense limit increase should be excluded from startup revenue calculations since the Commission has not yet reviewed these issues.

5. Since the $22 million AT&T billing and collection refund is a known effect of a prior Commission resolution, its annualized effects should be reflected in Pacific's startup revenue adjustment.

6. Since Pacific's new labor agreements have not been approved in a Commission resolution or decision, startup revenue adjustments should not reflect their annualized costs.

7. Since only $5.7 million of the estimated revenue loss from Pacific's intraLATA 800 service is expected to occur due to regulatory action, the startup revenue adjustments should be $2.85 million for Pacific and $520,000 for GTEC.

8. Since the Commission authorized revenue recovery of effects of a separations change for central office equipment and revenue accounting expenses, Pacific's annualized results should be adjusted to reflect the entire authorized 1989 expense level.

9. Since D.89-10-031 provides that rates should be adjusted by an amount needed to yield the market-based rate of return, Pacific's and GTEC's productivity accruals should not be reflected in annualized 1989 results.

10. Based on a 1990 settlements level between Pacific and GTEC of $195.288 million, Pacific's settlements amounts for GTEC included in its compliance filing should be reduced by $72.260 million.

11. Since no party challenged Pacific's estimate of its settlements obligation to local exchange carriers other than GTEC, Pacific's $94.236 million estimate should be used in determining

Pacific's 1990 startup revenue adjustment, subject to later true-up.

12. Because of significant uncertainty surrounding Pacific's 1990 settlements levels, both the $195.288 million settlements level adopted for GTEC and the $94.236 million settlements forecast for smaller local exchange carriers should be made subject to refund with later true-ups if needed.

13. Because it is uncontroverted, GNP-PI data published by the U.S. Department of Commerce should be used in the price cap indexing mechanism.

14. In order to balance goals of stability and timeliness, the inflation component of the price cap indexing mechanism should be the percent change in GNP-PI between June 30 of the current year and July 1 of the prior year.

15. Consistent with the degree of accuracy in published GNP-PI data, the percent change in GNP-PI used in the price cap indexing mechanism should be rounded to one digit after the decimal.

16. Consistent with Conclusions of Law 13, 14, and 15, the measure of inflation for the price cap indexing adjustment to be effective January 1, 1990 should be 4.9%.

17. Since for years after 1990 the price cap indexing mechanism will be applied to rates rather than revenues, the inflation minus productivity adjustment for 1990 should be applied to the 1989 billing base (adjusted for interLATA SPF-to-SLU shifts).

18. Since no party disputed 1989 annualized billing base data provided by Pacific and GTEC, these estimates (adjusted for interLATA SPF-to-SLU shifts) should be used in calculating 1990 startup revenue adjustments.

19. Consistent with Conclusions of Law 16, 17, and 18, 1990 inflation minus productivity adjustments should be $26.202 million for Pacific and $7.107 million for GTEC.

20. Because the adopted review process provides adequately for consideration of future cost changes, the portion of TURN's petition for modification of D.89-10-031 which requests that either (a) future cost changes not be considered as exogenous events in the price cap indexing mechanism or (b) forecasts of such future cost changes be trued up at year end should be denied.

21. Since Pacific's proposed 1990 adjustment of $7.52 million for the separations change for central office equipment and revenue accounting expenses is properly treated as an exogenous factor and is consistent with the revenue level authorized in Resolution T-13037, it should be reflected in Pacific's startup revenue adjustment.

22. Since no party disagrees with the DEM adjustments proposed by Pacific and GTEC, these adjustments should be reflected in the startup revenue adjustments.

23. Because Pacific has not shown that costs of complying with fire suppression and asbestos survey and removal requirements are significantly higher than costs of similar restrictions elsewhere in the nation, these costs should not be reflected in its startup revenue adjustment.

24. Consistent with D.88-09-030 and D.89-10-031, it is reasonable to continue USOAR turnaround adjustments as exogenous factors under the new regulatory framework.

25. Since it was uncontroverted, GTEC's USOAR turnaround estimate should be used in GTEC's startup revenue adjustment.

26. A 1990 USOAR turnaround effect of $21 million should be used for Pacific since it is consistent with Pacific's estimates both at the compliance workshop and in the USOA rewrite proceeding.

27. Since they are uncontroverted, Pacific's and GTEC's proposed adjustments for the direct assignment of WATS should be adopted.

28. Consistent with prior decisions, direct assignment of WATS adjustments including the corrections factor should be applied to exchange services only.

29. Benefits resulting from premature retirement of high coupon bonds should be excluded from startup revenue adjustments since the Commission has not yet reviewed this issue.

30. Depreciation updates for 1990 should not be included in a 1989 adjustment since recorded 1989 results reflect current approved depreciation rates for 1989.

31. Since DRA has not made any claim that 1990 depreciation updates would be due to extraordinary changes arising from exogenous events, 1990 depreciation updates should not be reflected in the price cap indexing mechanism as an exogenous factor.

32. GTEC's $1.973 million interstate Universal Service Fund funding reduction should be reflected as an exogenous factor in the price cap indexing mechanism, consistent with D.89-10-031.

33. For Pacific, an $11 million revenue adjustment should be made to reflect expenses related to switch replacement, consistent with D.89-10-031.

34. A startup revenue decrease of $392,554,000 for Pacific should be adopted as the net effect of reasonable adjustments set forth in preceding Conclusions of Law.

35. A startup revenue requirement increase of $32,224,000 for GTEC should be adopted as the net effect of reasonable adjustments set forth in preceding Conclusions of Law.

36. Because they are uncontroverted, the SPF-to-SLU revenue adjustments proposed by Pacific and GTEC should be adopted.

37. Pacific's proposal regarding contributions to a Bargained VEBA trust absent to and prior to adoption of such a requirement by FASB should not be considered because it does not fall within the scope of the compliance filings authorized by D.89-10-031.

38. Because it would allow a single net revenue adjustment later in 1990, GTEC's petition for modification of D.89-10-031

should be granted to the extent that GTEC should be allowed to accrue its authorized startup revenue adjustment (excluding direct assignment of WATS) in a memorandum account until (a) new discrete rates are established in the supplemental rate design proceeding or (b) application of the price cap index for 1991.

39. Consistent with D.89-10-031, startup revenue adjustments adopted in this decision should be implemented as uniform surcharge/surcredits to all intrastate access, intraLATA toll, and exchange services, including flexibly priced services, consistent with existing Commission practice. The only exception to this uniform applicability requirement other than that in Conclusion of Law 38 should be made for the adjustment for direct assignment of WATS, based on the methodology adopted in prior decisions.

40. The surcharges and surcredits to implement the adopted revenue adjustments which are set forth in Section VI of this decision should be adopted, consistent with prior Conclusions of Law.

41. In order to provide timely implementation of revenue changes adopted in this decision, this order should be effective today.

INTERIM ORDER

IT IS ORDERED that:

1. The petition for modification of Decision (D.) 89-10-031 filed by the Division of Ratepayer Advocates (DRA) is denied.

2. The portions of the petition for modification of D.89-10-031 filed by Toward Utility Rate Normalization (TURN) which request that the startup revenue adjustment be based on only the first six months of recorded data for 1989 and that either (a) future cost changes not be considered as exogenous events in the price cap indexing mechanism or (b) forecasts of such future cost changes be trued up at year end are denied.

3. For Pacific Bell (Pacific), 1990 revenues of $289,524,000 are authorized subject to refund pending a true-up for actual 1990 settlements amounts, excluding out-of-year settlements adjustments.

4. For GTE California Incorporated (GTEC), 1990 revenues of $195,288,000 are authorized subject to refund pending a true-up for actual 1990 settlements amounts, excluding out-of-year settlements adjustments.

5. As part of its October 1, 1990 advice letter filing required by Decision (D.) 89-10-031, Pacific shall report expected 1990 total settlements, excluding out-of-year settlements adjustments, and shall address whether a 1991 Z factor adjustment would be appropriate in light of the 1989 AT&T billing and collections adjustment adopted in this decision.

6. As part of its October 1, 1990 advice letter filing required by D.89-10-031, GTEC shall report actual and expected 1990 total settlements, excluding out-of-year settlements adjustments.

7. The inflation component of the price cap indexing mechanism shall be the percentage change in the Gross National Product Price Index, as published by the U.S. Department of Commerce, between June 30 of the current year and July 1 of the prior year and rounded to one digit after the decimal.

8. Pacific's 1990 surcredits and surcharges are reduced to yield a $390,554,000 revenue reduction effective January 1, 1990, consistent with the preceding discussion and the adjustments adopted in this decision.

9. GTEC's 1990 surcredits and surcharges are modified as set forth in Section VI of this decision, effective January 1, 1990. Consistent with the preceding discussion and the adjustments adopted in this decision, effective January 1, 1990, GTEC is authorized to record a $32.817 million annual revenue increase in a memorandum account, pending further Commission action.

10. The 1990 SPF-to-SLU adjustments proposed by Pacific and GTEC are adopted.

11. GTEC's petition for modification of D.89-10-031 is granted to the extent set forth in Ordering Paragraph 9 and Conclusion of Law 38.

12. The surcharges and surcredits to implement the adopted revenue adjustments which are set forth in Section VI of this decision are adopted.

13. The revised Common Carrier Line Charges reflected in the interLATA SPF-to-SLU sections of Pacific's and GTEC's compliance filings are adopted.

14. Within five days of the effective date of this order Pacific and GTEC shall file advice letters to be effective January 1, 1990 with revised tariff sheets to implement the surcharges, surcredits, and Common Carrier Line Charges adopted in this decision. Copies of the advice letters shall be served at the time of filing on all parties in I.87-11-033 and on anyone requesting such service.

This order is effective today.

Dated DEC 1 8 1989, at San Francisco, California.

G. MITCHELL WILK
President
FREDERICK R. DUDA
STANLEY W. HULETT
JOHN B. OHANIAN
PATRICIA M. ECKERT
Commissioners

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

Wesley Franklin

WESLEY FRANKLIN, Acting Executive Director

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