Decision 90 03 075 MAR 28 1990

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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, 1989 and May 19, 1986)
And Related Matters.	I.85-03-078 OII 84 Case 86-11-028

(See Appendix A for list of appearances.)

I N D E X

OPINION ADOPTING SETTLEMENT ON MODERNIZATION ISSUES IN PHASE III OF APPLICATION 85-01-034

Summary

This decision completes and concludes the Division of Ratepayer Advocates' (DRA) investigation into Pacific Bell's decision-making practices regarding modernization investments which began in 1985. This result is accomplished by adopting the "Settlement Agreement" executed by Pacific Bell and DRA on March 29, 1989, with certain clarifications of the work activities of SRI International (SRI) proposed therein, and of the data submissions to be made to DRA.

This decision also establishes the appropriate billing base to be applied to an annual amount of $36 million, for each of four 12-month periods following the effective date of this order, to establish a reasonable billing surcredit needed to flow through the benefits of the settlement to Pacific Bell's ratepayers.

Background

This issue of prudency of expenditures made by Pacific Bell to modernize its telephone plant was raised initially in December 1985 by the Public Staff Division, predecessor of the Commission's Division of Ratepayer Advocates (DRA)[1] during the course of its investigation and study of Pacific Bell's 1986 test year rate application (Application (A.) 85-01-034). In DRA's "Report on Plant Modernization of Pacific Bell" dated December 16, 1985 DRA recommended that Pacific Bell be penalized $43 million annually until it improved its decision-making practices regarding modernization investments.

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1 Hereafter the acronym DRA will be used to identify both the Division of Ratepayer Advocates and its predecessor, the Public Staff Division.

The Commission, with only a brief opportunity to consider DRA's December 16, 1985 report, by Decision (D.) 86-01-026 dated January 10, 1986, left these proceedings open to allow parties an opportunity to present testimony "on whether PacBell's modernization programs are in the best economic interests of ratepayers" along with several other unresolved issues. In doing so the Commission left Pacific Bell's revenues "subject to refund" pending completion of its consideration of the modernization issue.

Pacific Bell responded to DRA's recommendation by retaining Arthur D. Little, Inc. (ADL) to study its capital budgeting process and the reasonableness of its modernization expenses. ADL studied a selected sample of 132 modernization projects of Pacific Bell which had been approved prior to 1986. These sampled projects represented expenses of $940 million in an overall universe of $3.5 billion of Pacific Bell's authorized expenditures.

From its study ADL in April 1986 concluded that only 5 of the 132 sampled projects were partially unreasonable and all of the remaining 127 projects represented sound investments. ADL further determined that of the 5 projects which had partially unreasonable investments, the amount of questionable investment amounted to only $580,000. When extrapolated to Pacific Bell's overall $3.5 billion in total projects the total unreasonable investment would be $19.8 million, and the few errors made by Pacific Bell would thus have an insignificant effect on Pacific Bell's revenue requirement, according to ADL.

DRA urged that hearings on and receipt of ADL's report be deferred in order to allow it an opportunity to conduct an adequate review of the study. By D.86-06-021 dated June 4, 1986 the Commission granted DRA's petition for modification of the April 1, 1986 procedural schedule to defer hearings on the ADL study then scheduled for October 6-17, 1986 to a date to be set in August 1987. D.86-08-079 modified D.86-06-021, deferring DRA's penalty

recommendation, but stating that a preliminary policy-oriented decision on modernization questions might be issued at the conclusion of the proceeding.

In D.87-12-067 issued December 22, 1987, the Commission discussed Pacific Bell's policy related testimony containing seven guidelines for assessing the prudency of utility capital investment decisions (Id., mimeo. pp. 27-32). Essentially these guidelines suggest that regulators' prudency decisions: (1) be based on assessment of information available to the utility at the time the decision was made; (2) distinguish between "prudency" and "correctness"; (3) impose disallowances only when ratepayers have suffered adverse consequences; (4) evaluate on the basis of the corporation's overall effectiveness; (5) be premised on a sufficient number of samples to be fair to the utility; (6) assign value for all the measurable outcomes of the investment; and (7) consider the constraints under which the utility's investment decision was made.

While determining that these guidelines provide a helpful framework, the Commission declined to adopt them as the sole measure for assessing prudency, opting instead for a case-by-case approach based on the evidence presented in the record before it (D.87-12-067, mimeo., pp. 31-32).

Meanwhile, DRA had retained the firm of SRI to determine the reasonableness and propriety of Pacific Bell's modernization investment decisions, to assess the incremental revenue requirements attributable to unreasonable investment decisions, and to critique the ADL study. In doing this work SRI studied 40 of the 132 modernization projects previously analyzed by ADL representing expenditures of about $75 million. SRI issued reports in March and August of 1988 alleging potentially uneconomic investment in more than half of the approved estimates. SRI also asserted that 9 of the 40 approved estimates contained approximately $371,000 of uneconomic investment which SRI

extrapolated to a lower bound estimate of uneconomic investment of about $172 million.

In August 1988, DRA issued a report recommending that Pacific Bell's revenue requirement be reduced by $700 million on a one-time basis to test year 1986 results. This test year adjustment was alleged to cover imprudent investments for years 1984 through 1986, with rate base components carried forward into 1987 and 1988. The $700 million represented the total of a rate base component of $285 million and a process component of $155 million for years 1984-1986 and a post test year adjustment of $260 million for years 1987 and 1988.

DRA argues that the purpose of this adjustment was to encourage Pacific Bell "to correct any inadequacies in its investment process that might exist."

On August 10, 1988 this matter was assigned to Administrative Law Judge (ALJ) George Amaroli to plan and set hearings to settle the third and final phase of the issue. The assigned ALJ subsequently held four prehearing conferences on November 1, December 16, 1988, January 27, and February 24, 1989 which dealt primarily with Pacific Bell's preliminary efforts at full discovery of the work of SRI and DRA. By February 24, 1989, Pacific Bell had tendered literally hundreds of data requests to DRA and DRA was responding to them at a relatively slow pace, based on Pacific Bell's needs and expectations. DRA, by February 24, 1989, committed itself to providing full responses to all of Pacific Bell's data requests by March 31, 1989. Based on that schedule, and further discovery planned by Pacific Bell including probable and likely extensive depositions of DRA and SRI staff, Pacific Bell asserted that a realistic timetable for commencing Phase III modernization hearings would be early December 1989 after exchanging prepared testimony in mid-October 1989.

Faced with the frustration and extensive work in a discovery process that necessitated thorough and careful review of

data going back to calendar year 1984 for literally hundreds of project reviews, it became worthwhile and desirable for Pacific Bell and DRA to consider a possible settlement of their differences on the issue of a reasonable modernization adjustment. Therefore, with DRA prepared to support and defend a substantial one-time $700 million adjustment against Pacific Bell and Pacific Bell strongly disagreeing with the findings, conclusions, and recommendations of SRI, Salazar-Oakford Company (SOC),[2] and DRA, Pacific Bell and DRA, on or about March 1, 1989, began serious discussions leading to a possible settlement.

The Proposed Settlement

On March 10, 1989 Pacific Bell and DRA jointly filed a proposed settlement agreement "to settle all claims related to or arising out of the modernization proceedings" as a part of Phase III of A.85-01-034.

Notice was also given as part of the Pacific Bell-DRA joint filing of March 10, 1989, that a settlement conference would be convened on "Wednesday, March 22, 1989, at 1:30 p.m. in the California Public Utilities Commission hearing room, 505 Van Ness Avenue, San Francisco..." "to afford to all parties the opportunity to discuss, pursuant to Rule 51.1 of the Commission's Rules of Practice and Procedure, Pacific's and the DRA's proposed settlement..."

Then, on March 29, 1989, Counsels representing DRA and Pacific Bell jointly filed a "Motion to Adopt and Approve Settlement" and appended thereto a "Settlement Agreement" executed by them on that same date. (See Appendix B.)

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2 The Salazar-Oakford Company was a consulting firm retained by SRI to provide an independent evaluation of SRI's review of Pacific Bell's capital investment decision-making process.

Objections[3] to the settlement agreement were timely filed by the Center of Public Interest Law of the University of San Diego (CPIL) and Toward Utility Rate Normalization (TURN) within the 30-day comment period set forth in Rule 51.4 of the Commission's Rules of Practice and Procedure.

While CPIL and TURN raised other concerns, the two significant objections that warranted further attention are:

1. The adequacy of the dollar amount of the proposed settlement ($36 million in rate adjustments for a four-year period); and

2. The overall relationship between Pacific Bell, SRI, and DRA relative to future investment decisions and the adequacy of the evaluation process being proposed for review of those decisions.

Details of these issues were summarized on page 6 of CPIL's March 16, 1989 request for hearing on the settlement proposal as follows:

> "PacBell and DRA propose to stipulate to conditions that avoid gathering the basic information absolutely necessary for the Commission to do its job competently. Instead, PacBell agrees to pay $36 million in an annual revenue reduction in each of four years. This amount is <u>not</u> a significant percentage of gross revenues. PacBell agrees to negotiate with SRI (a private concern) in an 'interactive, nonadversarial process' (whatever that means) an 'evaluation' of appropriate modifications of Pacific's investment decisions in these areas:
>
> "1) Non-guideline driven investment justifications;
>
> "2) Engineering guideline justification;

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3 Timely comments were also received from AT&T Communications of California (AT&T-C), Northern Telecom, Inc. (Northern), and various independent local exchange telephone companies (LECs). AT&T-C and the independent LECs do not oppose the settlement and Northern supports the agreement.

"3) Documentation standards and their enforcement;

"4) Training/professional development needs; and

"5) Peer reviews including feedback process.

"Leaving aside the substanceless jargon to which professional consulting firms are addicted, this proposed procedure avoids the gathering or presentation or review of the basic information the regulator must have to evaluate a major investment: (1) What is its impact on the utilization of current fixed plant in the existing monopoly loop upon which ratepayers must rely and which is the most fundamental concern of the regulator? (2) What is the impact in terms of marketplace intrusion from monopoly power sourced financing?"

With those objections in mind the assigned ALJ awaited the issuance of D.89-10-031, on October 12, 1989 presenting the Commission's Interim Opinion on Phase II of Order Instituting Investigation (I.) 87-11-033. By that order the Commission established a new regulatory framework for Pacific Bell and GTE California Incorporated (GTEC).

That decision will employ price caps and an indexing mechanism to establish a requirement for sharing of excess earnings with ratepayers, above a benchmark rate of return, in lieu of the traditional "Rate Base" method of determining allowable earnings (rate of return) on net utility investment. Thus, the settlement agreement would now apply in this new regulatory framework and would also be considered in making adjustments to the initial rates, and for developing the indexing mechanism established pursuant to that order.

Accordingly on October 12, 1989 the assigned ALJ, by ruling, set three days of hearings commencing November 20, 1989, to consider the issues and concerns of CPIL and TURN, as noted above, and directed Pacific Bell and DRA to appear and present testimony

on those limited issues. The ALJ ruling required that Pacific Bell and DRA serve their prepared testimony on the parties to this proceeding by October 30, 1989.[4] All other parties were invited to participate in the examination of Pacific Bell and DRA witnesses at the hearings.

GTEC and the other LECs were also placed on notice that their settlement revenues may be affected by further determinations of the Commission on the proposed settlement and they may present evidence or comment as appropriate on that matter.

The hearings concluded on the first day (November 20, 1989) and yielded 163 pages of transcript, on the matters dealing with "Phase III Modernization Issues" of A.85-01-034. Testimony on the issues previously outlined in the ALJ ruling was taken from two witnesses, one for Pacific Bell and one representing DRA. Five exhibits were identified, three were received at the hearing, and two late-filed exhibits were to be distributed by December 1, 1989. CPIL and TURN were permitted to file further exceptions and comments on the proposed settlement, or before December 8, 1989 and Pacific Bell and DRA were given until December 22, 1989 to reply to CPIL and TURN's exceptions and comments. The record on the "Phase III Modernization Issues" of A.85-01-034 was submitted on December 22, 1989, upon receipt of the Pacific Bell and DRA replies to TURN's[5] exceptions and comments of December 8, 1989.

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4 A three-day extension of time to November 2, 1989 was subsequently granted to Pacific Bell and the DRA for filing testimony due to the dislocations resulting from the Bay Area earthquake of October 17, 1989.

5 CPIL did not file further exceptions or comments on the settlement agreement before the due date of December 8, 1989.

Hearing Summary

The November 20, 1989 hearing on the motion to adopt and approve the March 29, 1989 settlement agreement on "Modernization" focused on the following two issues:

1. The adequacy (present worth) of the dollar amount of the proposed settlement and how to incorporate it into the rate design to be adopted for Pacific Bell in its new regulatory framework; and

2. The overall relationship between Pacific Bell, SRI, and DRA relative to the evaluation of future investment decisions carried out under the new regulatory framework adopted in D.89-10-031.

Pacific Bell's Charles L. McCreight, as Director of State Regulatory Matters, with 21 years of service with Pacific Bell and The Pacific Telephone and Telegraph Company presented testimony on these issues.

DRA called Louis G. Andrego, a Program Manager with 27 years of broad experience with the Commission in the field of telecommunications regulation, to testify on these same issues.

Both McCreight and Andrego were closely involved in the "Modernization" issues from the start and are considered to be experts on the proposed "Settlement Agreement."

Adequacy of Settlement Amount

On the first issue, regarding the present worth in dollars of the settlement and its adequacy, McCreight stated that the dollar amount of the proposed settlement was $36 million for each of four successive years. He computed that the present worth

of that settlement would be about $119 to $126 million[6] (Ex. 2-M[7] p. 3).

McCreight contended that the settlement was reasonable in view of the widely divergent positions of Pacific Bell and DRA, and that the settlement eliminates protracted and costly litigation (Ex. 2-M p. 3).

He emphasized that Pacific Bell believes that it had rebutted DRA's claims and had established that its actions were prudent. In approaching the settlement it was apparent to him that both Pacific Bell and DRA were going to vigorously defend their respective positions. He asserted that the negotiated settlement amount does not attempt to presuppose what the Commission would have decided based upon all the evidence which would have been entered into the record, but instead, recognizes the parties' positions "...and that the continued path of litigation, which began in 1985, would be extremely costly and time-consuming." (Ex. 2 p. 4.)

Andrego also agreed, based on his calculations, that the present worth of the settlement was about $119-$126 million. As to the adequacy of that settlement amount, Andrego opined that "...any component of the settlement must be viewed in terms of the entirety of the settlement." (Ex. 3-M p. 4.)

Andrego contended that DRA viewed the settlement in its entirety as resolving a previously recommended revenue adjustment referred to in DRA's August 1988 Staff Report, consisting of three components, namely:

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6 Although not stated in the exhibit the range was apparently determined using a range of values for the time value of money to determine the present worth.

7 The letter "M" has been added to the five exhibits received in this "Modernization Phase" to eliminate possible confusion with other exhibits in A.85-01-034.

"1. Compensation to ratepayers for the amount of test year 1986 economic harm incurred and flowed through to ratepayers.

"2. Compensation to ratepayers for economic harm incurred for years beyond 1986.

"3. Motivation for improvement in the on-going investment decision process of Pacific Bell to reduce the needless ratepayer burden of uneconomic harm." (Ex. 3-M p. 5.)

DRA also considered the fact that the Commission had not provided a standard of care for evaluation of uneconomic investment as part of its perspective in entering the proposed settlement. Andrego further opined that of the two components of the staff's proposed 1986 adjustment, namely, a $285 million rate base component, and a $155 million process component, the latter was less likely to be adopted for potential uneconomic investment (Ex. 3-M pp. 5-6).

For years beyond 1986 Andrego felt even more uncertain of the probable acceptance by the Commission of the DRA recommended $130 million/year adjustment. Andrego reasoned that:

"Given those compounded uncertainties, DRA shifted from the uncertainty of a Commission adopted adjustment to the virtual certainty of significant savings from an accelerated adoption of our long-term recommendations by a willing utility." (Ex. 3-M pp. 6-7.)

In response to questions from the ALJ about DRA recommended versus Commission adopted adjustments regarding Pacific Gas and Electric Company's Diablo Canyon and Southern California Edison Company's San Onofre nuclear power plants, Andrego said that he was aware of them and he had checked out the "SONGS", San Onofre Power Plant Units 2 and 3 additions of $4.5 billion total cost. He contended that in that proceeding the DRA staff had hard evidence, based on documented delays, of an adjustment of about $1 billion. He noted, however, that the Commission adopted approximately

$260 million, or 26% of the amount recommended by DRA staff (Tr. 22342-22343).

Counsel for TURN had previously asked McCreight if there was a particular formula behind the settlement amounts. McCreight replied no, that the amounts were "merely negotiated" during the settlement discussions (Tr. 22198).

At the hearings, TURN's counsel also elicited varied background information on the studies conducted by DRA and its consultants, then the focus was shifted to the second significant issue.

The Relationship of Pacific Bell, SRI, and DRA Relative to the Evaluation of Future Investment Decisions

Relative to the Pacific Bell, SRI, and DRA relationship, McCreight testified that:

> "The intent of the proposed settlement is to identify and implement potential efficiency improvements into Pacific's modernization investment practices. Pacific, SRI, and the DRA will participate in this process." (Ex. 2-M p. 6.)

McCreight also noted that the relationship was not a permanent one and will continue only to the point of completion of the terms and conditions of the settlement agreement.

Andrego explained the relationship and reasons for it stating:

> "SRI was hired by the Division of Ratepayer Advocates in September of 1986 to carry out an audit of Pacific's investment decision making processes. Over the two and one-half year period that SRI and DRA have worked together, an effective and co-ordinated team has developed. Seasoned expertise of this team was not instantly available at the beginning of the project but took an extensive period to develop. During this period SRI and DRA have been able to become intimately familiar with Pacific's investment decision making practices. The effective and efficient implementation of

> this settlement agreement now requires the expertise and knowledge gained over the last two and one-half years. DRA is unaware of any recognized consulting firm which could provide such seasoned expertise as SRI." (Ex. 3-M pp. 9-10.)

Andrego further explained that the agreement protects DRA's right to participate in all meetings, discussions, and evaluations that take place between SRI and Pacific Bell which relate to the implementation of the requirements of this paragraph. This right to participate, moreover, is further protected by the requirement that either Pacific Bell or SRI shall notify the DRA of any scheduled meetings between Pacific Bell and SRI that are planned to implement the provisions of the agreement. Andrego also notes that the agreement specifically mandates that the DRA will monitor and retain its oversight responsibilities throughout the implementation of the agreement.

Lastly, Andrego opined that SRI's efforts and work products under the agreement will continue to assist Pacific Bell under the new regulatory framework, as follows:

> "Upon completion of the SRI contract terms Pacific management will have in place an improved and efficient investment decision making process including peer review and feedback. Given the incentive based framework adopted it would be reasonable to assume that Pacific management would fully utilize the improved process to maximize its earnings which in turn would mean possible sharing with ratepayers and consequently lower rate levels. From a regulatory review perspective failure by the utility to utilize the improved processes would result in 'penalties' in the form of lower earnings. The manner in which Pacific's post settlement investments would be evaluated will be determined by whatever monitoring specifics are implemented pursuant to finding No. 181 of Decision 89-10-031." (Ex. 3-M p. 14.)

TURN and CPIL cross-examined McCreight at length regarding the definitions of the specific work areas for SRI under the settlement agreement.

Thereafter, the ALJ asked DRA and Pacific Bell to work together and prepare late-filed Exhibit 4-M further defining the five items of work of SRI noted on Page 6 of the settlement agreement in one convenient place (Tr. 22344).

The ALJ also granted TURN's request for a late-filed Exhibit 5-M giving details of any contractual agreements between Pacific Bell and/or The Pacific Telephone and Telegraph Company and SRI during the last five years.

On November 30, 1989, Pacific Bell served late-filed Exhibit 4-M on the parties, containing the following detailed "Description of Five Recommendation Areas in Settlement Agreement", which it prepared jointly with the DRA:

"Non-Guideline driven investment justifications

"Non-guideline investments are those investments or specific situations that, because of their uniqueness, do not have a specific alternative or recommended solution that can be given to them. These would require their own specific analysis by the engineer using a particular DCF (discounted cash flow) type of analysis to compare alternatives that could be proposed in that particular situation. We would look at all relevant cash flows: Capital, Revenue and Expenses; and other inputs for the engineer to arrive at a recommended alternative or recommended solution to that particular situation.

"Engineering guideline justifications

"These are the types of ordinary, repetitious investment decisions that an engineer would make on a day-to-day basis. These types of investments would have commonality between them for all engineers doing these same types of decisions. Guidelines set engineering parameters and conditions under which

repetitive investment decisions are made. Guidelines are based upon demonstrable analyses. They improve the efficiency and productivity of the engineers by eliminating the need for them to do a bottoms-up study on each one of these types of investments.

"Documentation standards and their enforcement

"These standards define the content and scope of the underlying analyses and justification that are included in an investment recommendation package. The analyses provided will ensure that the various managers responsible for reviewing and ultimately approving an investment recommendation are presented with all of the relevant facts and issues prior to their approval of the investment recommendation. The investment recommendation package also serves as an archival file so that the underlying basis or justification of an investment decision can be reviewed at a later time.

"Training/professional development needs

"This category includes the types of Pacific Bell training and development processes that our engineers have in place and also the types of training to be conducted for those particular changes and enhancements that would be agreed upon as part of this settlement.

"Peer reviews, including feedback process

"This is a process wherein you have a particular entity or group that would review investment decision packages to examine the procedures that were undertaken to arrive at the decision, the types of documentation prepared, and the types of studies that were performed to ensure consistency and adherence to those standards that are in place for that decision-making process. These evaluations would include a feedback process to ensure that compliance and improvements are in place and that inconsistencies are rectified." (Late-filed Ex. 4-M pp. 1-2.)

Subsequently, on December 1, 1989 Pacific Bell provided TURN with copies of six contractual agreements for services of SRI to The Pacific Telephone and Telegraph Company and Pacific Bell during the period of May 1983 through to the present date, as part of late-filed Exhibit 5-M, which TURN had requested. (Tr. 22205.)

TURN's Comments and Recommendations

Thereafter, on December 8, 1989, TURN filed "Comments and Recommendations of Toward Utility Rate Normalization on the Proposed Settlement." Basically TURN recommended that the settlement be approved with the following significant modifications:

1. A provision should be added to the settlement agreement that would require DRA or the Commission Advisory and Compliance Division (CACD) approval prior to disbursements of any funds to SRI under the provisions of the settlement agreement that require Pacific Bell and SRI to enter into a contract.

2. A provision should be added to the settlement agreement that would mandate that any contract between SRI and Pacific Bell should include a provision granting ownership of SRI's work product jointly to both Pacific Bell and DRA/CACD.

3. A provision should be added to the settlement agreement that clearly indicates DRA's and CACD's authority to hire SRI in related projects.

4. Phase I and Phase II of the settlement agreement should be amended to include DRA and/or CACD participation.

5. Phase III of the settlement agreement should be amended to require that DRA and/or CACD should be briefed on the implementation of the adopted work plans on a regular basis, at least every 6-8 weeks on an as-needed basis.

6. Phase IV of the agreement should be amended to require DRA and/or CACD to file a report commenting on the quality of Pacific Bell's compliance while including suggestions for additional measures which should be taken by the utility. In addition these reports should then be offered to the public and intervenors for comment before the Commission signifies that Pacific Bell's work is complete.

7. All refunds should be through a surcredit mechanism which recognizes the disproportionate economic harm suffered by residential ratepayers.

On December 22, 1989 Pacific Bell and DRA replied to TURN's comments and recommendations on the proposed settlement. Pacific Bell asserted that:

> "TURN's Comments must be evaluated in light of its extremely limited participation in the modernization issue raised in this proceeding. TURN did not conduct any discovery or present any testimony or other evidence related to the modernization issue in Phase II of this proceeding. Nor did TURN conduct any discovery or attend any prehearing conferences in Phase III of this proceeding prior to the one-day hearing on November 20, 1989. In fact, TURN asked to become a part of this proceeding only after Pacific and the DRA announced the Settlement. TURN's comments and recommendations reflect its lack of participation in the series of events leading up to the Settlement.
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> "In contrast Pacific and the DRA have participated in this issue from its genesis in early 1985. During the past five years these two parties have devoted considerable time and resources to exploring this issue. Not only did Pacific and the DRA investigate the issue themselves, they hired independent consultants, Arthur D. Little ('ADL') and SRI International, respectively, to assist them (Mr. McCreight (for Pacific) Exh. 2, pp. 3-4). Furthermore, they pursued their respective investigations in a highly adversarial manner. With this

knowledge and background, these parties are in the best position to negotiate a settlement, and the procedures for its implementation, which reflects the public interest.

"TURN's Comments also reflect TURN's desire to modify existing Settlement terms and add new terms, whether or not these modifications are necessary. Every writer knows that a certain idea can be expressed in a number of different ways. It is not surprising, therefore, that TURN can identify alternative ways of expressing points already addressed in the Settlement. But the mere fact that TURN can identify alternatives does not mean those alternatives are any better than the expressions already in the Settlement. In fact, the wording used by the DRA and Pacific reflects the fact that the DRA and Pacific have gained knowledge and expertise in the subject matter over the last five years and consequently were able to negotiate and craft a settlement that is workable and serves the public interest."

Pacific Bell then argued that TURN's comments and recommendations are without merit and the Commission should reject them.

DRA in its December 22, 1989 reply also urged rejection of TURN's recommended changes as follows:

"While DRA recognizes the ratepayer concerns expressed by TURN in its comments and recommendations, we strongly urge the Commission to reject these recommendations and adopt the proposed settlement as submitted. We would remind the Commission that the proposed settlement represents the give and take of negotiations. We believe that it is a carefully crafted agreement which includes checks and balances that we feel protect the interest of both the ratepayers and the stockholders of Pacific. Not only do TURN's arguments supporting their recommendations lack an understanding of the intent of the agreement, but they also fail to present persuasive reasoning that should justify modification of the existing agreement.

> Finally, many of the concerns expressed by TURN were taken into consideration in negotiating the settlement."

Discussion

While we appreciate Pacific Bell's reply comments and concerns, describing TURN's limited participation in the modernization issues prior to the formal review of the "Settlement Agreement" at the November 20, 1989 hearing, we do not intend to categorically reject all of TURN's recommendations as urged by both it and DRA. However, we are not prepared to complicate the "Settlement Agreement" by introducing further oversight requirements by either CACD or any other entity which is not a signatory to that agreement at this time. With these general observations as a background, we will consider two areas of concern for revision of the agreement to:

1. Better define the role and work of SRI in its responsibilities under the "Settlement Agreement" and,

2. Clarify any possible misunderstanding as to DRA's opportunities for ongoing involvement in the review of SRI's work products.

We will also separately address the manner in which a surcredit should be applied to provide reasonable equity to all ratepayers to mitigate disproportionate benefit distribution.

Defining and Describing the Work of SRI

CPIL surfaced these issues as part of its March 16, 1989, request for hearing on the settlement. More recently TURN cross-examined Pacific Bell's witness at length on these areas for review and possible modification of Pacific Bell's future investment decisions under the settlement. Ultimately Pacific Bell and DRA jointly prepared late-filed Exhibit 4-M providing a detailed description of the five recommendation areas in the settlement agreement. We believe that the details contained in late-filed

Exhibit 4-M should be made part of the agreement, as an appendix thereto, and will so require.

Clarifying the Role of the DRA

TURN, in its December 8, 1989 comments and recommendations, asks us to require "that DRA and/or CACD approve all disbursements to SRI under the contract either on a monthly or quarterly basis."

We are not convinced that there is any need to require a monthly or quarterly analysis of work performed by SRI simply to support or reject Pacific Bell's payment for SRI's services. We are not aware of any similar prior review by the DRA of other contractual deliverables to Pacific Bell with subsequent payment. This fiscal encroachment on Pacific Bell's contract with SRI appears unnecessary at this time.

However, we do intend that DRA be, at all times, kept fully aware of all product and services deliveries to Pacific Bell. Therefore, we will require Pacific Bell to instruct SRI to also mail or otherwise deliver copies of any and all documents, letters, studies, and any other materials routinely provided to Pacific Bell, to the DRA, simultaneously with its mailing or alternative distribution of these materials to Pacific Bell.

Accordingly, DRA, at any time, for any just reason or cause may use "General Provision 5.g"[8] of the "Settlement Agreement" titled "Disputes" as a last resort to resolve disputes arising, not only from the implementation of the agreement, but also to challenge any perceived poor work performance of SRI which

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8 General Provision 5.g. states:

"Disputes. The DRA and Pacific Bell agree that any dispute or failure to agree arising from the implementation of this Agreement shall, as a last resort, be submitted to the presiding ALJ for resolution."

is not otherwise corrected through ongoing discussions between DRA and Pacific Bell.

Apportionment of Revenue Reduction Surcredit

TURN refers to DRA's August 5, 1988 report on Pacific Bell's capital decision-making process, noting that residential ratepayers were disproportionately harmed by Pacific Bell's poor investment choices. TURN further asserts that this same observation was made by DRA's consultant. Therefore, TURN in its December 8, 1989 comments and recommendations argued for a distribution of one-half of the revenue as a surcredit to residential ratepayers only, and the remaining one-half to all of Pacific Bell's ratepayers including residential ratepayers.

This TURN contends "will guarantee that residential ratepayers will be properly compensated for the disproportionate harm they suffered."

While we are interested in a reasonable distribution of the settlement revenues to all of Pacific Bell's customers on an equitable basis, we are reluctant to establish still a new base for surcharges and surcredits.

We recently established three annual billing bases for Pacific Bell's surcharges and surcredits in this proceeding by D.89-12-048 dated December 18, 1989. The three billing bases correspond to Exchange, intraLATA Toll, and Access revenues.

From these existing bases, we will choose the Exchange billing base of $3,253,722,000[9] as the most apparent equitable base to fairly and uniformly distribute the surcredit benefit resulting from the settlement during the interim period while the surcredit is applicable. However, we will conform this interim

9 As contained in Pacific Bell's November 7, 1989 compliance filing pursuant to Ordering Paragraph 14 in D.89-10-031, issued on October 12, 1989 in this proceeding.

outcome with our decision on supplemental rate design in I.87-11-033; therefore, parties interested in this issue may participate there. We have excluded the intraLATA Toll billing base since its use would skew the apportionment of benefits to large toll users which utilize substantial toll for their business or personal needs.

Using the Access billing base would further apportion the surcredit to the larger interLATA and interstate users.

We believe that by spreading the surcredit to the Exchange billing base, each Pacific Bell customer will receive a surcredit benefit based on the services subscribed for. Customers who already receive rate benefits under the Universal Lifeline Telephone Service and from the Deaf and Disabled Telecommunications Programs will receive lesser surcredits based on their already reduced rates for exchange service.

This method of allocation of surcredit benefit appears to satisfy certain of the basic concerns raised by TURN without the need for developing a costly and cumbersome new billing base.

With these clarifications, and the development of an appropriate bill and keep surcredit to be applied to Pacific Bell's customer billings over the next 48 months, we will direct the distribution of $36 million each year for the four-year period provided for in the "Settlement Agreement" and bring a fruitful conclusion to a long and intense modernization investigation which the DRA began in early 1985. Upon conclusion of the distribution of the $36 million annually over the full 48 month period, Pacific Bell may file an advice letter to have the $36 million annual revenue reduction eliminated.

With this modernization investment issue settled by this order, Pacific Bell can devote its efforts to improving its overall operations as it proceeds to implement the new regulatory framework adopted by D.89-10-031 issued October 12, 1989, and may benefit

further by the work of SRI as provided for in the "Settlement Agreement" which we will adopt and approve herein.

Comments: ALJ's Proposed Decision

In accordance with PU Code § 311, the ALJ draft decision prepared by ALJ George Amaroli was issued on February 9, 1990. Timely comments on the proposed decision were filed by AT&T-C, DRA, Pacific Bell and TURN.

AT&T-C objected to the exclusive use of the exchange billing base for determination of refunds related to the settlement herein. DRA sought correction of certain citation errors and requested that "mailing" of documents by SRI be expanded to include other forms of distribution of those materials and communications, as may be appropriate from time to time. Pacific Bell also sought minor citation corrections, and the placement of $3 million per month of settlement revenues in a balancing account for later distribution with other surcharges and surcredits rather than the immediate distribution contemplated by the order. Pacific Bell also requested clarification of its ability to use the advice letter process to eliminate the $36 million annual revenue reduction after conclusion of the 48 month settlement period. TURN requested that the contemporaneous submissions of documents by SRI to DRA include copies of all bills for services rendered by SRI to Pacific Bell.

Except as set forth in their comments all parties, other than AT&T-C, stated that they supported the ALJ's proposed decision on the settlement. AT&T-C made it clear that it was addressing a single issue in its comments, leading to the obvious conclusion that it also, otherwise supported the ALJ's proposed decision.

DRA, Pacific Bell and TURN filed timely reply comments. In its "Reply" comments DRA objected to Pacific Bell's request to delay the disposition of the revenue reduction by establishing a balancing account. DRA asserts that Pacific Bell had not raised this issue in either the settlement hearings or the briefs it filed

thereafter. DRA asserts that the modernization decision is long overdue and the Commission would be in error in adopting this last minute recommendation of Pacific. DRA also suggested that as a means to reduce Pacific's administrative costs the 1.1064% surcredit could be made effective on May 1, 1990 along with the effective date of Advice Letter 15674 pertaining to productivity sharing. Pacific Bell's "Reply" comments objected to the additional oversight now being recommended by TURN regarding review of SRI billings by the DRA.[10]

TURN's "Reply" comments objected to AT&T-C's request to include intraLATA toll and interLATA access customer revenues in the revenue base for the settlement. TURN's objections were buttressed with citations of examples of targeted surcharges and surcredits in other decisions of the Commission. TURN also objected to the recommendation of Pacific Bell to establish a balancing account as an attempt to contravene the purpose of the settlement.

We have carefully reviewed the comments of AT&T-C, DRA, Pacific Bell and TURN together with the "Reply" comments of DRA, Pacific Bell and TURN and determined that we will make the citation and other corrections suggested by DRA and Pacific Bell. We have added language to the narrative of this order allowing Pacific Bell to file an advice letter to eliminate the $36 million annual revenue reduction after conclusion of the 48 month settlement agreement revenue reduction period. We have also recognized the need for distribution methods other than by mail for documents and other communications prepared or delivered by SRI to Pacific Bell and DRA. However, we have not adopted the balancing account

10 DRA filed further Reply comments on March 8, 1990 contending that it had not received TURN's comments until March 6, 1990. In its late "Reply" comments, DRA joined Pacific Bell in opposing TURN's recommendation that DRA review SRI's bills.

recommendation of Pacific Bell or the spreading of settlement revenue reductions to intraLATA toll and interLATA access customer billings as suggested by AT&T-C. Creation of a balancing account would merely delay the long awaited settlement revenue reduction and would also be a breach and delay of the actual settlement as noted by DRA in its reply comments.

AT&T-C's toll customers are also local exchange customers and thereby share equally with other similar residence or business customers in the settlement surcredit proposed herein. The possible exception would be coin telephone users and those customers are not targeted in surcredit distributions either herein or in other prior decisions.

To include toll usage would skew the revenue reduction benefits to larger toll users and reduce benefits to small toll users. However, as we have stated earlier we will address the concerns of parties including AT&T-C in our examination and determination of issues on supplemental rate designs in I.87-11-033 where AT&T-C is free to advance its concerns and recommendations. Meanwhile, each of AT&T-C's customers, who is also a customer of Pacific Bell will share on an equivalent basis with all other exchange customers in the provisional revenue reduction surcredit adopted herein.

Findings of Fact

1. On March 10, 1989 Pacific Bell and the DRA jointly filed a proposed settlement agreement pursuant to Rule 51 of the Commission's Rules of Practice and Procedure to settle all claims related to or arising out of the modernization proceedings as a part of Phase III of A.85-01-034.

2. Notice of the time and phase of a settlement conference scheduled for March 22, 1989 as required by Rule 51.1 was given in the joint filing dated March 10, 1989, noted above.

3. On March 29, 1989 Pacific Bell and the DRA jointly filed a "Motion to Adopt and Approve Settlement" and appended thereto a

"Settlement Agreement" executed on that same date pursuant to Rule 51.3, as set forth in Appendix B hereto.

4. CPIL and TURN filed timely objections to the settlement agreement within the 30-day comment period set forth in Rule 51.4.

5. Northern filed timely comments supporting the proposed settlement.

6. AT&T-C and various LEC's filed timely comments stating that they did not oppose the proposed settlement.

7. CPIL's and TURN's objections were primarily directed to the adequacy of the dollar amount of the proposed settlement and to the ongoing relationship of Pacific Bell, SRI, and the DRA relative to the evaluation process being developed for review of future investment decisions.

8. In view of the ongoing evaluation of the new regulatory framework for Pacific Bell in this same proceeding, the modernization settlement review was held in abeyance until after the issuance of D.89-10-031 in this proceeding on October 12, 1989.

9. TURN and CPIL cross-examined the Pacific Bell and DRA witnesses at the November 20, 1989 hearing on the two substantive issues noted earlier; thereafter, only TURN filed further comments on a timely basis, on December 8, 1989.

10. TURN's December 8, 1989 comments and recommendations did not challenge the dollar amount of the proposed settlement, but did recommend that it should be primarily distributed to residential ratepayers which TURN contends suffered a disproportionately greater econonic harm from Pacific Bell's past modernization investment practices.

11. While we have not accepted TURN's apportionment formula, which would have necessitated an additional base or bases for calculation of surcredits, we have elected to use only the exchange billing base, developed in this proceeding, to reasonably flow through the surcredit to all of Pacific Bell's customers without

diluting the amount of benefit to small toll users, which would occur if other billing bases were included.

12. TURN's recommendations to bring CACD into the settlement agreement, to review the ongoing work of SRI, and/or to approve SRI's billings to Pacific Bell prior to payment were opposed by both Pacific Bell and the DRA and are not adopted herein.

13. Based on the provisions of the settlement agreement and the record developed at the hearing, it is reasonable to require that SRI furnish copies of all of its work products contemporaneously to the DRA and Pacific Bell.

14. It is clear from CPIL's and TURN's initial comments and objections to the proposed settlement that the definitions of the specific work areas for SRI were not clear.

15. The DRA and Pacific Bell jointly prepared late-filed Exhibit 4-M further defining the five specific areas of work for SRI noted on Page 6 of the settlement agreement. It is reasonable to require that these clarifying definitions be appended to and made part of the "Settlement Agreement" proposed for adoption herein.

16. The $36 million annual revenue reduction that Pacific Bell has offered to flow through to its customers each year for four years (48 months) is reasonable for the purpose of adopting the proposed "Settlement Agreement".

17. The proposed "Settlement Agreement", as clarified by this order, will bring a reasonable and final conclusion to a lengthy and intense investigation that began early in 1985 into Pacific Bell's modernization investment practices.

Conclusions of Law

1. The March 29, 1989 proposed "Settlement Agreement" on the Phase III modernization investment issues in A.85-01-034 is reasonable in light of the hearing record, consistent with law and in the public interest as set forth in Appendix B of this order, and as clarified by appending thereto the definitions set forth in

Appendix C to this order, and should be approved and adopted consistent with the following conclusions of law.

2. Pacific Bell should be directed to instruct SRI to mail or otherwise deliver to the DRA copies of any and all documents, letters, studies, or any other materials routinely, or irregularly, provided to Pacific Bell under the "Settlement Agreement", simultaneously with its mailing or alternative distribution of these materials to Pacific Bell.

3. Pacific Bell should be required to develop a bill and keep 1.1064% surcredit by applying the $36 million annual revenue reduction contained in the proposed settlement agreement, as a numerator and the $3,253,722,000 Exchange billing base developed elsewhere in this proceeding as a denominator, and to apply that surcredit to exchange services in accordance with Schedule Cal. P.U.C. A2, Rule 33 - Billing Surcharges for 48 calendar months except as treatment of this surcredit may be modified by further order of this Commission in the supplemental rate design phase of I.87-11-033.

4. Pacific Bell should be required to file an advice letter, within 30 days after the effective date of this order, to implement the surcredit discussed in Conclusion of Law 3 above; the tariff revisions should go into effect on May 1, 1990. Contemporaneously with tariff revisions filed by Advice Letter 15674 to reduce administrative costs and customer inquiries.

5. This order should be made effective today to provide these long awaited revenue reductions to Pacific Bell's ratepayers without further delay.

O R D E R

IT IS ORDERED that:

1. The proposed March 29, 1989 "Settlement Agreement" executed by the Commission Division of Ratepayer Advocates (DRA)

and Pacific Bell on "Modernization" issues in Phase III of A.85-01-034 as set forth in Appendix B hereto is adopted with the following conditions:

a. The clarifying definitions contained in Appendix C to this order shall be appended to the settlement agreement and be made a part thereof, and

b. Pacific Bell shall instruct SRI to mail or otherwise distribute to the Director of the DRA copies of any and all documents, letters, studies, or any other materials routinely or irregularly provided to Pacific Bell under the "Settlement Agreement", simultaneously with its like provision of these materials to Pacific Bell.

2. Within 30 days after the effective date of this order, Pacific Bell shall file an advice letter and associated tariff sheets, in compliance with General Order 96-A, to implement a bill and keep surcredit of 1.1064% applicable to exchange services in accordance with Pacific Bell's Schedule Cal. P.U.C. A2, Rule 33 - Billing Surcharges. The tariff revisions shall become effective on May 1, 1990. The surcredit shall remain effective for 48 months following the effective date of the tariff revisions, unless and except as treatment of this surcredit is modified by further order of this Commission in I.87-11-033.

3. The "Modernization" investigation of the DRA into Pacific Bell's investment practices associated with Phase III of A.85-01-034 is closed.

This order is effective today.

Dated MAR 28 1990, at San Francisco, California.

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

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

NEAL J. SHULMAN, Executive Director
SB

APPENDIX A

LIST OF APPEARANCES

Applicant: Daniel J. McCarthy, Jackie Holmes, and Greg Castle, Attorneys at Law, for Pacific Bell.

Respondents: Messrs. Davis, Young & Mendelson, by Jeffrey F. Beck and Sheila A. Brutoco, Attorneys at Law, for CP National, Citizens Utilities Company of California, Evans Telephone Company, GTE West Coast Incorporated, Happy Valley Telephone Company, Hornitos Telephone Company, Kerman Telephone Company, Pinnacles Telephone Company, Sierra Telephone Company, The Siskiyou Telephone Company, Tuolumne Telephone Company, The Volcano Telephone Company, and Winterhaven Telephone Company; Kim C. Mahoney, for CP National Corporation; and A. J. Smithson, for Citizens Utilities Company of California.

Interested Parties: Messrs. Cooper, White & Cooper, by E. Garth Black and Mark P. Schreiber, Attorneys at Law, for Roseville Telephone Company, Calaveras Telephone Company, California-Oregon Telephone Company, Ducor Telephone Company, Foresthill Telephone Company, and The Ponderosa Telephone Company; Randolph Deutsch, Attorney at Law, for AT&T Communications of California, Inc.; Robert Fellmeth and James Wheaton, Attorneys at Law, for Center for Public Interest Law; Graham & James, by Martin A. Mattes, Attorney at Law, and Janice Hill, Attorney at Law, for California Cable Television Association; William G. Irving, for County of Los Angeles; Jerry O'Brien and Diane Martinez, for API Alarm Systems; Kenneth K. Okel and Kathleen S. Blunt, Attorneys at Law, for GTE California Incorporated; Earl Nicholas Selby, Attorney at Law, for Bay Area Teleport; Cecil O. Simpson, Attorney at Law, for U.S. Department of Defense and all other Federal Executive Agencies; Sidney Webb, for himself; Alan Weiss and Pat Chow, Attorneys at Law, for MCI Telecommunications; Orrick, Herrington & Sutcliffe, by Robert J. Gloistein, Attorney at Law, for Contel of California, Inc.; Norman T. Stout, for Northern Telecom, Inc.; William S. Shaffran, Attorney at Law, for City of San Diego; Mark Barmore, Attorney at Law, for TURN; and August A. Sairanen, Jr., for California Department of General Services, Telecommunications Division.

Division of Ratepayer Advocates: Lionel B. Wilson, Attorney at Law, Louis Andrego, and David H. Weiss.

Commission Advisory and Compliance Division: Kevin P. Coughlan.

(END OF APPENDIX A)

APPENDIX B

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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
And related proceedings.	I.85-03-078 OII 84 Case 86-11-028

MOTION TO ADOPT AND APPROVE SETTLEMENT

The Division of Ratepayer Advocates (the "DRA") and Pacific Bell ("Pacific") pursuant to Rule 51.3 of the Commission's Rules of Practice and Procedure do hereby jointly move the California Public Utilities Commission ("CPUC") to adopt the Settlement Agreement which is attached hereto as Exhibit "A", resolving all issues of all parties related to modernization proceedings specified below. The DRA and Pacific believe that this settlement is reasonable, consistent with applicable law and in the public interest. The parties move for adoption of this settlement on the basis that all of the elements of the settlement be adopted, without modification unless agreed to by the parties.

APPENDIX B

The DRA and Pacific desire to settle all claims of all parties[1] related to or arising out of modernization proceedings involving Pacific pending before the Commission, including issues raised in:

(1) the DRA's December 16, 1985 report entitled "Report on Plant Modernization of Pacific Bell"; (2) Decision 86-01-026; (3) Decision 87-12-067; (4) the report entitled the "Audit of Pacific Bell Modernization Investment Decisions" dated April 18, 1986 and prepared by A.D. Little, Inc.; (5) Phases 2 and 3 of Application 85-01-034; (6) the report prepared by SRI International entitled "A Review of Pacific Bell's Capital Investment Decision Making Process" dated March 1, 1988, as revised by a report dated August 5, 1988; (7) the report prepared by Salazar Oakford Company entitled "An Independent Evaluation of SRI International's Review of Pacific Bell's Capital Investment Decision-Making Process dated June 8, 1988 as revised by a report dated August 5, 1988; and (8) the DRA report entitled "Staff

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[1]Prior to the Settlement Conference, the Center for Public Interest Law ("CPIL") filed "Objections" to the settlement. The DRA and Pacific believe that CPIL's objections, based upon the alleged failure to consider its EIS proposal, are without merit. CPIL has been alloved to incorporate into the record of OII 87-11-033, which is currently pending before ALJ Ford, its testimony from Phase 2 of A.85-01-034, as well as related testimony from Phase 1 of that proceeding (See, OII Transcript, Vol. 53 at pages 6647-6649). It is not the intent of the DRA or Pacific by this Settlement to settle the merits of CPIL's proposal which is currently pending in OII 87-11-033. CPIL's proposal, subject to the positions taken by various parties, will be considered in OII 87-11-033. The DRA and Pacific reserve the right to address more specifically any objections raised by CPIL when comments are filed in accordance with Rule 51.4.

Report on Pacific Bell's Capital Decision-Making Process" dated August 5, 1988.

THE SETTLEMENT IS IN THE PUBLIC INTEREST

This settlement is in the public interest because:

1. The long-term best interests of ratepayers and Pacific are best achieved by timely implementation of appropriate modifications in Pacific's modernization investment decision-making practices, and not by protracted, costly litigation;
2. Pacific has agreed to review its modernization investment decision-making practices and implement appropriate modifications which will result in future benefits to ratepayers in the form of more cost effective and efficient decision-making;
3. Improvements in Pacific's modernization investment decision-making practices would advance the likely accrual of significant future benefits to ratepayers by at least 2 years, during which time a substantial amount of Pacific's capital investments (which currently exceed $1 billion annually) would begin to utilize such improved practices;
4. Under the terms of the settlement, significant benefits will be provided to customers of Pacific by reducing future annual rates by $36 million for a 4 year period; and
5. Without settlement, final resolution of the modernization issues would not likely occur until the

end of 1991, almost 10 years after the first project under review was initiated. The process has been and was expected to continue to be lengthy due to the complexity and multiplicity of issues requiring substantial prehearing discovery, including numerous depositions of witnesses, data request preparation and response, possible additional rebuttal reports, as well as the time necessary for the DRA and Pacific to analyze this information.

COMPLIANCE WITH THE COMMISSION'S SETTLEMENT RULES

On Wednesday, March 22, 1989, a Settlement Conference was held pursuant to Rule 51.1 of the Commission's Rules of Practice and Procedure. At the Settlement Conference, several parties and interested persons who had not filed appearances in this matter raised various questions and sought clarification regarding the settlement. As a result of these questions, the DRA and Pacific have made changes to the original proposed settlement.

For the foregoing reasons, it is respectfully requested that the attached Settlement Agreement be approved and adopted.

APPENDIX B

Dated this 29th day of March, 1989, at San Francisco, California.

Respectfully submitted,

LIONEL B. WILSON
Staff Counsel

Division of Ratepayer Advocates
California Public Utilities Commission
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Attorney for the DRA

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San Francisco, CA 94105
Telephone: (415) 546-5733

Attorneys for Pacific Bell

APPENDIX B

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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
And related proceedings.	I.85-03-078 OII 84 Case 86-11-028

SETTLEMENT AGREEMENT

BACKGROUND

The prudence of certain modernization expenditures made by Pacific Bell ("Pacific") was initially questioned by the Division of Ratepayer Advocates ("DRA") during the capital recovery portion of Pacific's 1986 Rate Case (Application 85-01-034) and subsequently, in a report issued by the DRA entitled "Report on Plant Modernization of Pacific Bell," dated December 16, 1985 ("December 1985 report"). The DRA alleged in its December 1985 report that Pacific had "mismanaged its modernization effort to the detriment of ratepayers" and recommended that Pacific be penalized $43 million annually until Pacific demonstrated improvement in its modernization investment decision-making practices.

APPENDIX B

In response to the DRA's report, in Decision 86-01-026, the California Public Utilities Commission ("the Commission") ordered hearings on the "modernization" issue and held that all of Pacific's revenues be "subject to refund" pending completion of the Commission's review of several areas, including modernization.

In response to allegations made by the DRA regarding its modernization program, Pacific retained Arthur D. Little, Inc. ("ADL") to review its capital budgeting process and the reasonableness of its modernization expenditures. ADL selected a sample of 132 modernization projects, as represented by estimates, approved prior to 1986. These estimates represent expenditures of approximately $940 million out of a universe of approximately $3.5 billion of authorized expenditures. ADL issued its report in April 1986 and concluded that of the 132 estimates, 127 were sound investments and 5 were partially unreasonable. ADL alleged that these 5 estimates contained $580,000 of unreasonable investment and, when extrapolated to the ADL universe of $3.5 billion, at the 95 percent confidence level, there would be $19.8 million of unreasonable investment. However, ADL concluded that the few errors Pacific had made had an insignificant effect on Pacific's rate base and revenue requirement.

Upon motion by the DRA, receipt into evidence of the ADL report was deferred. Thereafter, the DRA retained the firm of SRI International ("SRI") to: determine the reasonableness and appropriateness of Pacific's modernization investment decisions,

assess the incremental revenue requirements attributable to decisions SRI contended were unreasonable, and review the ADL study. To accomplish these tasks, SRI reviewed a subset of 40 out of the 132 modernization projects reviewed by ADL. These 40 projects, as represented by approved estimates, represent expenditures of $75 million. SRI issued reports in March and August of 1988 which alleged potential uneconomic investment in over half of these approved estimates. Based upon the information available, SRI alleged that 9 of the 40 approved estimates contained approximately $371,000 of uneconomic investment which, when extrapolated to the SRI universe at the 90 percent confidence level, resulted in a lower bound estimate of uneconomic investment of $172 million.

In August 1988, the DRA issued a report which, based upon SRI's lower bound estimate, recommended that Pacific's revenue requirement be reduced by $700 million on a one time basis.

The $700 million rate adjustment proposed by the DRA included a test year adjustment and a post test year adjustment. The test year adjustment, covering the years 1984-1986, amounted to $440 million and had two components: a rate base component and a process component. The rate base component tracked with the SRI 40 project audit review estimate period and reflected capital investments allegedly containing quantified uneconomic investment. This rate base component adjustment amounted to $285. million. The process component was intended as an estimate of possible economic harm from allegedly deficient investment

decisions where actual economic harm could not be determined or quantified because of the lack of data. It was derived by denying for one year the authorized return on equity for such investments and amounted to $155 million.

The post test year adjustment for the years 1987 and 1988 equalled $260 million, assuming the same level of deficiencies as alleged for the 1984-86 period, but did so without audit verification. The purpose of this adjustment was to encourage Pacific to correct any inadequacies in its investment process that might exist.

SCOPE OF THE AGREEMENT

The DRA and Pacific hereby agree to settle all claims related to or arising out of the modernization proceedings, including issues raised in the DRA's December 1985 Modernization report, Decision 86-01-026, Decision 87-12-067, the ADL Report, Phase 2 of Application 85-01-034 and the SRI, Salazar Oakford Company ("SOC") and DRA Reports (including supplements thereto) issued as a part of Phase 3 of Application 85-01-034.

TERMS OF AGREEMENT

The DRA and Pacific agree as follows:

1. Pacific agrees to reduce future rates by including $36 million in the annual revenue reduction dollars currently available for Supplemental Rate Design ("SRD"). The $36 million shall be identified by Pacific during the SRD proceeding as incremental to the balances of the previously Commission ordered

components which will comprise the rate design phase (e.g., USOAR, Tax Reform, Attrition, etc.). The $36 million annual revenue reduction shall be effective upon implementation of SRD, which is a part of the Commission's current investigation into alternative regulatory frameworks (I. 87-11-033), and shall terminate four years later. In the event that there has been no decision on SRD on or before January 2, 1990 or if such a decision is not forthcoming, the DRA and Pacific may file a joint petition to modify this Agreement in order to implement the $36 million four year annual revenue reduction provided for hereunder.

2. In order to allow Pacific the time necessary to evaluate and implement appropriate changes to its modernization investment decision-making practices, taking into account associated cost-benefits, there will be no audit or follow-up audits of modernization investment decisions which are studied, approved or implemented by Pacific prior to the full implementation of all workplans identified in Paragraph 4 below or the end of 1990. Notwithstanding the foregoing, throughout the implementation of this Agreement, the DRA shall retain its regulatory oversight and monitoring responsibilities with respect to Pacific's operations, and Pacific shall continue to make reasonable and prudent investment decisions.

3. Pacific agrees to enter into a contract with SRI in which Pacific agrees to pay SRI's customary and reasonable charges related to implementation of Paragraph 4 below; provided however, that SRI's charges for all work performed shall not

exceed an amount which shall be agreed to by Pacific and the DRA prior to execution of the contract between Pacific and SRI.

4. In order to efficiently implement appropriate changes in Pacific's modernization investment decision-making practices which are in the best interests of Pacific's ratepayers, the DRA and Pacific have agreed to the following schedule of activities:

a. Phase I. Within approximately two (2) months after approval of the settlement by the Commission, SRI and Pacific, through an interactive, nonadversarial process, shall evaluate in detail SRI's recommendations which relate to the following five areas, and shall mutually agree upon the appropriate modifications in Pacific's modernization investment decision-making which should be implemented in these areas:

1) Non-guideline driven investment justifications;

2) Engineering guideline justifications;

3) Documentation standards and their enforcement;

4) Training/professional development needs;

5) Peer reviews including feedback process.

b. Phase II. Within approximately two (2) months after agreeing upon which recommendations listed under Phase I above are appropriate, Pacific shall, in conjunction with SRI, develop a comprehensive workplan to implement the recommendations.

c. Phase III. Pacific shall implement the workplans developed during Phase II. Subject to Paragraph 4(f) below, the DRA and Pacific agree that the approximate time periods required to implement the workplans for each recommendation shall be as follows:

1) Non-guideline driven investment justifications (approximately 6-12 months);

2) Engineering guideline justifications (approximately 6-12 months);

3) Documentation standards and their enforcement (approximately 6-12 months);

4) Training/professional development needs (approximately 12-18 months);

5) Peer reviews including feedback process (approximately 6-12 months).

During the implementation of each workplan, SRI shall meet periodically with Pacific to review, monitor and discuss with Pacific implementation of each workplan. As provided in Paragraph 4(e) below, Pacific and SRI shall periodically review the status of Phase III with the DRA. SRI shall notify the DRA within 2 weeks after full implementation of all workplans.

d. Phase IV. Within 6 months after full implementation of all workplans as noticed in Phase III, (i) Pacific shall file a compliance report with the Commission detailing the implementation of the workplans described in Phase II, (ii) SRI shall

certify to the DRA as to SRI's involvement in the implementation of the activities described in this Paragraph 4 and that Pacific has implemented the workplans described in Phase II, and (iii) the DRA will file SRI's certification with the Commission and provide copies of it to all parties. The failure of Pacific to file the compliance report may subject Pacific to sanctions which the Commission may deem appropriate.

e. The DRA, pursuant to its continuing monitoring and oversight responsibilities, as set forth in Paragraph 5(c) of this Agreement, may participate in all meetings, discussions and evaluations between Pacific and SRI that take place in implementing the activities required by this Paragraph. Either Pacific or SRI shall provide the DRA timely notice of all scheduled meetings between Pacific and SRI that are held to plan and/or implement the requirements of this Paragraph.

f. The time periods referred to in this Paragraph 4 are approximate and may be modified as necessary and as mutually agreed to by the DRA and Pacific. Notice of all modifications of time periods set forth in this Agreement shall be provided to the Executive Director of the Commission.

5. General Provisions

a. No Admission. This Agreement is entered into in full compromise of disputed claims. It is acknowledged by the DRA and Pacific that the execution of this Agreement is not and shall not be construed as an admission of imprudence, wrong-doing or liability and that this Agreement reflects a mutual desire to move expeditiously in resolving the present dispute and doing so in the interest of all parties.

b. Statutory Obligations. Nothing contained herein shall modify the Commission's statutory obligations to regulate Pacific.

c. DRA Oversight. The DRA shall monitor and retain its oversight responsibilities throughout the implementation of this Agreement.

d. Removal of SRI. Pacific and DRA may by mutual agreement terminate the use of SRI's services provided that an alternative is mutually agreed to.

e. Inadmissibility. In accordance with Rule 51.9 of Commission's Rules of Practice and Procedure, no discussion, admission, concession or offer to stipulate or settle, whether oral or written, made during any negotiation regarding a stipulation or settlement shall be subject to discovery or admissible in any evidentiary hearing against any participant who objects to its admission.

f. General Order No. 66-C. SRI shall comply with and be bound by the Commission's General Order No. 66-C.

g. Disputes. The DRA and Pacific agree that any dispute or failure to agree arising from the implementation of this Agreement shall, as a last resort, be submitted to the presiding ALJ for resolution.

h. Release. Provided that Pacific implements the requirements of Paragraph 4 of this Agreement, the DRA agrees that it will not pursue any claim, demand, cause of action, damage, liability of any nature whatsoever, embodied or which could have been embodied in modernization phases of this proceeding, and within the scope of this Agreement as defined above.

i. Further Documents. The DRA and Pacific agree to execute such other or further documents or instruments and to take such other or further action as may be necessary or desirable to implement the terms and provisions of this Agreement.

j. Entire Agreement. This writing constitutes the entire agreement between the DRA and Pacific. No modification or waiver of this Agreement shall be valid unless in writing and approved by the Commission. Neither the DRA nor Pacific shall be

bound by any representation, promise, statement or information unless it is specifically set forth herein.

k. No Precedent. This Agreement represents a compromise, and the DRA and Pacific have entered into it on the basis that the Commission's adoption of the terms and conditions set forth herein not be construed as a precedent in any current or future proceeding. The issues resolved by this Agreement should not be construed as reflecting either party's views or position except as a reasonable and appropriate compromise of the issues involved.

l. Interpretation. This Agreement shall in all respects be interpreted, enforced and governed exclusively by and under the laws of the State of California in effect when this settlement is approved by the Commission. This Agreement is to be deemed to have been jointly prepared by the DRA and Pacific, and all uncertainty or ambiguity existing herein shall not be interpreted against either party.

m. Execution. This Agreement may be executed in one or more counterparts, each of which shall be deemed an original, but all of which, together shall constitute one and the same instrument.

n. Approval by CPUC. This Agreement shall be effective upon approval by the Commission.

APPENDIX B

THIS AGREEMENT IS IN THE PUBLIC INTEREST

The settlement reached by Pacific and the DRA is in the public interest because:

1. The long-term best interests of ratepayers and Pacific are best achieved by timely implementation of appropriate modifications in Pacific's modernization investment decision-making practices, and not by protracted, costly litigation;
2. Pacific has agreed to review its modernization investment decision-making practices and implement appropriate modifications which will result in future benefits to ratepayers in the form of more cost effective and efficient decision-making;
3. Improvements in Pacific's modernization investment decision-making practices would advance the likely accrual of significant future benefits to ratepayers by at least 2 years, during which time a substantial amount of Pacific's capital investments (which currently exceed $1 billion annually) would begin to utilize such improved practices;
4. Under the terms of the settlement, significant benefits will be provided to customers of Pacific by reducing future annual rates by $36 million for a 4 year period; and

5. Without settlement, final resolution of the modernization issues would not likely occur until the end of 1991, almost 10 years after the first project under review was initiated. The process has been and was expected to continue to be lengthy due to the complexity and multiplicity of issues requiring substantial prehearing discovery, including numerous depositions of witnesses, data request preparation and response, possible additional rebuttal reports, as well as the time necessary for the DRA and Pacific to analyze this information.

IN WITNESS WHEREOF, the parties execute this Agreement effective March 29, 1989.

DIVISION OF RATEPAYER ADVOCATES

By: Lionel B. Wilson

Title: Staff Counsel

Date: 3/29/89

PACIFIC BELL

By: [signature]

DANIEL J. McCARTHY

Title: Senior Counsel

Date: 3/29/89

(END OF APPENDIX B)

Late-Filed Exhibit No. 4 in Phase III of A.85-01-034
Description of Five Recommendation Areas in Settlement Agreement

Non-Guideline driven investment justifications

Non-guideline investments are those investments or specific situations that, because of their uniqueness, do not have a specific alternative or recommended solution that can be given to them. These would require their own specific analysis by the engineer using a particular DCF (discounted cash flow) type of analysis to compare alternatives that could be proposed in that particular situation. We would look at all relevant cash flows: Capital, Revenue and Expenses; and other inputs for the engineer to arrive at a recommended alternative or recommended solution to that particular situation.

Engineering guideline justifications

These are the types of ordinary, repetitious investment decisions that an engineer would make on a day-to-day basis. These types of investments would have commonality between them for all engineers doing these same types of decisions. Guidelines set engineering parameters and conditions under which repetitive investment decisions are made. Guidelines are based upon demonstrable analyses. They improve the efficiency and productivity of the engineers by eliminating the need for them to do a bottoms-up study on each one of these types of investments.

Documentation standards and their enforcement

These standards define the content and scope of the underlying analyses and justification that are included in an investment recommendation package. The analyses provided will ensure that the various managers responsible for reviewing and ultimately approving an investment recommendation are presented with all of the relevant facts and issues prior to their approval of the investment recommendation. The investment recommendation package also serves as an archival file so that the underlying basis or justification of an investment decision can be reviewed at a later time.

Training/professional development needs

This category includes the types of Pacific Bell training and development processes that our engineers have in place and also the types of training to be conducted for those particular changes and enhancements that would be agreed upon as part of this settlement.

Peer reviews, including feedback process

This is a process wherein you have a particular entity or group that would review investment decision packages to examine the procedures that were undertaken to arrive at the decision, the types of documentation prepared, and the types of studies that were performed to ensure consistency and adherence to those standards that are in place for that decision-making process. These evaluations would include a feedback process to ensure that compliance and improvements are in place and that inconsistencies are rectified.

Dated: November 30, 1989

(END OF APPENDIX C)