ALJ/MFG/jft

Mailed

OCT 15 1991

Decision 91-10-018 October 11, 1991

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 authorization to increase rates due to the adoption of generally accepted accounting principles for compensated absence expenses.	Application 90-11-031 (Filed November 19, 1990)

Michael D. Sasser, Attorney at Law, for Pacific Bell, applicant.
Kathleen S. Blunt and Kenneth K. Okel, Attorneys at Law, for GTE California, Incorporated; Randolph Deutsch, Attorney at Law, for AT&T; Orrick, Herrington & Sutcliffe, by Robert J. Gloistein, Attorney at Law, for Contel of California, Inc.; and Thomas J. Long, Attorney at Law, for Toward Utility Rate Normalization; interested parties.
James S. Rood, Attorney at Law, James Pretti, and Francis Fok, for Division of Ratepayer Advocates.

OPINION

Request

By its application, Pacific Bell seeks authority to increase rates for the recovery of $281.776 million of compensated absences[1] (vacation) expense, to be amortized over a ten-year period beginning January 1, 1988. Pacific Bell also requests that interest be calculated on the uncollected revenue requirement beginning January 1, 1988, consistent with Decision (D.) 88-09-030 and Resolution F-627 dated September 12, 1990.

1 Compensated absences represent the salary expense for employees' earned but unused vacation, personal days, floating holidays, and compensation days plus loadings.

Pacific Bell proposed to reflect this rate increase beginning on January 1, 1991, in the surcharge/surcredit applicable to intraLATA exchange and private line, toll, and access services, in accordance with its tariff Schedule Cal. P.U.C. No. A2, Rule 33.

Background

On February 11, 1987, we instituted an investigation to determine whether the Federal Communications Commission's (FCC) Part 32, Uniform System of Accounts for Telephone Companies (USOA) should be adopted for telephone companies subject to our jurisdiction. A controversial aspect of Part 32 was the FCC's adoption of Generally Accepted Accounting Principles (GAAP)[2] for accounting purposes and its automatic adoption of future GAAPs, unless the telephone utilities are notified to the contrary by the FCC.

By D.87-12-063 we adopted the FCC's USOA, including GAAP currently in effect, except as otherwise provided in the decision. We did not adopt the FCC's automatic adoption of future GAAP.

D.87-12-063 specifically adopted GAAP treatment for compensated absences. This meant that the accrual method of accounting is to be used for compensated absences. That is, cost is to be recorded as an expense in the year that the liability is incurred, and not delayed until the year that a cash payment is actually made. Pursuant to this decision, Pacific Bell was authorized to initiate a balancing account,[3] to be terminated on or before January 1, 1989, and to record the revenue impacts

2 GAAP are a common set of accounting concepts, standards, procedures, and conventions which are recognized by the accounting profession as a whole and upon which most nonregulated enterprises base their external financial statements and reports.

3 A balancing account provides for the recording and tracking of specific cost activities in the utility's accounting records to be reflected in the utility's financial statements.

resulting from adoption of the FCC's USOA. The embedded compensated absences liability as of December 31, 1987, was to be amortized over a ten-year period to ease rate shock.

However, Pacific Bell could not determine its embedded compensated absences liability until it updated its employee data base. Therefore, D.88-09-030 authorized Pacific Bell to exclude its compensated absences GAAP expense impacts from its USOA balancing account, and to seek recovery of such impacts through an advice letter filing.

Pacific Bell completed an update of its data base and, on February 2, 1990, filed Advice Letter 15697 seeking authority to recover its compensated absences revenue impact. The Division of Ratepayer Advocates (DRA) protested the filing and alleged that, among other matters, Pacific Bell's proposal to include projected 1988 compensated absences expense impacts as a 1987 expense is not in conformance with GAAP.

Upon review of the advice letter filing, DRA's protest, and Pacific Bell's response, we issued Resolution F-627, dated September 12, 1990. This resolution authorized Pacific Bell to recover $45.402 million associated to 1985, 1986, and 1987 compensated absences revenue impacts. However, it deferred consideration of Pacific Bell's request to recover its projected 1988 expense impacts due to insufficient evidence. The resolution did authorize Pacific Bell to file an application with testimony addressing the appropriateness of recovering its projected 1988 compensated absences impact; Pacific Bell filed this application on November 19, 1990.

Hearing

A prehearing conference was held on January 4, 1991, and evidentiary hearings were held on March 25 and March 26, 1991. Pacific Bell's Brian E. Thorne (Thorne), Director of Corporate Research and Analysis, and Robert B. Hetler (Hetler), a partner

of Coopers & Lybrand, an international accounting and consulting firm, testified on behalf of Pacific Bell.

James D. Pretti (Pretti), Deputy Director of DRA, and Francis W. Fok (Fok), a Public Utility Regulatory Program Specialist I, testified on behalf of DRA. Kenneth K. Chew (Chew), a financial consultant, testified for Toward Utility Rate Normalization (TURN).

This proceeding was submitted upon the receipt of concurrent briefs filed by AT&T, DRA, Pacific Bell, and TURN on April 30, 1991.

Issue

The issues in this proceeding are whether Pacific Bell's projected 1988 compensated absences impact to be earned in 1987 by Pacific Bell employees satisfies GAAP requirements, and whether Pacific Bell is entitled to recover such cost pursuant to D.87-12-063.

The GAAP standard applicable to compensated absences is Statement of Financial Accounting Standard (SFAS) No. 43. Paragraph 6 of this statement requires an employer, such as Pacific Bell, to accrue a liability for employees' compensation for future absences if four conditions are met. These four conditions are:

a. The employer's obligation is attributable to employees' services already rendered.

b. The obligation relates to rights that vest or accumulate.

c. Payment of the compensation is probable.

d. The amount can be reasonably estimated.

Only the first condition is disputed by the parties. The remaining three undisputed conditions will not be addressed further.

Pacific Bell's Position

Thorne asserts that the inclusion of projected 1988 compensated absences in 1987 is in compliance with GAAP, as defined by SFAS No. 43. He explained that the projected 1988 compensated absences amount represents Pacific Bell's cost of employees' vacation vested[4] on January 1, 1988. Since Pacific Bell had an obligation to compensate its employees in 1988 for vacation time vested on January 1, 1988, Thorne asserts that the projected obligation was attributable to work performed in 1987, the prior year.

Thorne also explained that it is company policy to vest its employees' vacation time on January 1 of each year. Pacific Bell does not require the employee to work another day past January 1 to be compensated for that entire year's vacation time. For example, an employee who terminates employment with Pacific Bell on January 1 is paid the full amount of vacation vested on January 1 of that year. Those employees who remain with Pacific Bell may take the full vacation to which they are entitled any time beginning January 1 of that year. Such employees do not earn any additional vacation for that year.

Hetler corroborated Thorne's testimony that Pacific Bell's treatment of projected 1988 compensated absences expense is in compliance with SFAS No. 43. According to Hetler, as of December 31, 1987, it was probable that Pacific Bell's employees would be paid in a subsequent period for increased benefits attributable to accumulated rights vested on January 1, 1988.

Hetler relied on Appendix A, Paragraph 12 of SFAS No. 43 to substantiate his position. This cited paragraph states that a

4 SFAS NO. 43 defines vested as rights for which the employer has an obligation to make payment even if an employee terminates; thus, they are not contingent on an employee's future service.

liability for amounts to be paid as a result of employees' rights to compensated absences should be accrued in the year that the benefit is earned. It also cited an example of how this policy is applicable for new employees. If a new employee receives vested rights to two weeks' paid vacation at the beginning of the employee's second year of employment with no pro-rata payment in the event of termination during the first year, the two weeks' vacation would be considered to be earned by work performed in the first year, and accrual for vacation pay would be required for the new employee during the first year of service.

Hetler further explained that the compensated absences liability definition does not limit Pacific Bell's liability solely to rights to compensation for those absences that eventually vest. This is because the definition also encompasses a constructive obligation for reasonably estimable compensation for past services that, based on the employer's past practices, probably will be paid and can be reasonably estimated.

<u>DRA's Position</u>

DRA opposes the recovery of Pacific Bell's projected 1988 compensated absences on two bases. First, DRA contends that the projected amount is not in accordance with GAAP, and second, that it is not sound regulatory policy to allow Pacific Bell to recover projected 1988 compensated absences.

<u>GAAP</u>

DRA's Fok provided three reasons why Pacific Bell's proposal is not in accordance with GAAP. His first reason is that the projected 1988 amount represents vacation vested on January 1, 1988 for vacation to be earned in 1988. Fok asserts that, because it was not attributable to employees' services already rendered in 1987, it does not meet the first condition of SFAS No. 43 which requires the employer's obligation to be attributable to employees' services already rendered.

Fok's second reason is that the accrual of projected 1988 compensated absences as a 1987 expense would defeat the purpose of accrual accounting, and would effectively recognize two years of compensated absences expense (1987 and 1988) in one year. In support of this position, Fok relies on the Statement of Financial Accounting Concepts No. 6 which states that accrual accounting uses accrual, deferral, and allocation procedures whose goal is to relate revenues, expenses, gains, and losses to periods to reflect an entity's performance during a period instead of merely listing its cash receipts and outlays. Thus, recognition of revenues, expenses, gains, and losses and the related increments or increments in assets and liabilities, including the matching of costs and revenues, allocation, and amortization, is the essence of using accrual accounting to measure performance of entities. The goal of accrual accounting is to account in the periods in which they occur for the effects on an entity of transactions and other events and circumstances, to the extent that those financial effects are recognizable and measurable.

Fok's third reason is that if projected 1988 expenses were recognized in 1987, then Pacific Bell's financial statements would be deficient of comparability. He explains that comparability is one of the qualitative characteristics of accounting information identified by the Financial Accounting Standards Board in its Statement of Concepts No. 2. Comparability enables users to identify and explain similarities and differences between two sets of economic phenomena. Therefore, recognizing projected 1988 expenses in 1987 results in recognizing two years of expenses in one year of income. Fok asserts that comparing net earnings between 1987 and 1988 would provide distorted results.

<u>Regulatory Policy</u>

DRA's Pretti testified that regardless of how GAAP requirements are interpreted, Pacific Bell's request should be rejected solely on the basis of sound regulatory principles. To do

otherwise would require ratepayers to provide additional revenue requirements for the vesting of vacation benefits prior to the time they are actually earned by employees. Pretti is also concerned that if Pacific Bell's proposal is adopted, other California utilities will be inclined to adopt a similar vacation policy for their employees and request similar regulatory treatment, resulting in requests for revenue requirement increases that could exceed one billion dollars.

TURN's Position

Similar to DRA's witnesses, TURN's witness, Chew, testified that Pacific Bell's projected 1988 compensated absences expense is not in accordance with GAAP. Chew based this conclusion upon his review of the application, Pacific Bell's testimony, DRA's testimony, Resolution F-627, and 32 years of accounting experience.

On brief, TURN echoes DRA's assertion that Pacific Bell's own written interpretation of its compensated absences policy shows that the projected 1988 compensated absences were earned in and attributable to 1988, and not earned in or attributable to 1987. TURN submits that Pacific Bell has failed to demonstrate that the projected 1988 compensated absences were earned in 1987.

Even if we conclude that Pacific Bell is correct, TURN argues that policy considerations weigh in favor of not recognizing the projected 1988 compensated absences as a 1987 expense for ratemaking purposes because such recovery would allow Pacific Bell rate recovery for the expenses of two periods in one period, or "double dipping."

Discussion

There is no dispute that D.87-12-063 adopted the GAAP accrual method for recording and recovering compensated absences expense. At issue is an interpretation of SFAS No. 43, a statement issued by the accounting profession which we adopted for the regulated telecommunications utilities.

To resolve this issue, as is the case in the issuance of most rules, it is necessary to interpret the statement. That is, we must determine whether Pacific Bell's accrual method conforms with the statement and whether Pacific Bell's requested rate recovery conforms with D.87-12-063.

The statement was issued by the accounting profession and not through a Commission proceeding. Therefore, we must rely on testimony presented in this proceeding to determine whether Pacific Bell's vacation policy meets the statement criteria. Of the five expert witnesses that testified in this proceeding, four are certified public accountants and one a chartered accountant. Two of these expert witnesses interpreted Pacific Bell's treatment of compensated absences to be in conformance with the statement while the remaining three witnesses interpreted that it was not in conformance with the statement.

Consistent with Hetler's position, we must determine what Pacific Bell's vacation policy is, independent of what GAAP says. Therefore, we review Pacific Bell's administrative instructions as an authoritative source to determine its vacation policy.

System Instruction (SI) No. 106 and a July 7, 1989 memorandum from Pacific Bell's Executive Vice President-Human Resources were the only written vacation policy procedures introduced into evidence. The SI states in relevant parts that Pacific Bell grants eligibility for vacation at the beginning of the calendar year in advance of the time the vacation is actually earned. In other words, employees are entitled to vacation on January 1 of each year for work to be performed during that specific calendar year. Employees who quit on January 1 of a year are entitled to receive compensation for the vacation they are eligible for at the beginning of that year. If an employee works the entire year, that employee will not earn any additional vacation. Also, if an employee quits on December 31 of the prior year, that employee is not entitled to any vacation on January 1.

The Pacific Bell July 7, 1989 memorandum, as testified by Pretti, states in part that following the first year of employment, an employee becomes vested on January 1 of each year in the full amount of vacation to which he/she is entitled during that year. Again written policy states that vacation to be vested on the first of the year is applicable to services expected to be performed during that year.

Thorne asserted that SI instructions should not be relied on as an authoritative source because SIs are for the use of payroll clerical employees and employees as a body to define the administration of vacation policy. Rather, reliance should be placed on accounting technical instructions (AI). However, in response to the administrative law judge's inquiry, Thorne acknowledged that Pacific Bell does not have an AI that addresses vacation policy.

Testimony from DRA's Fok substantiated that contracts between Pacific Bell and its employees' unions adopt Pacific Bell's vacation policy as promulgated in SI No. 106.

Pacific Bell's written SI No. 106 policy, its lack of an AI vacation policy, and the presence of written union contracts which adopts Pacific Bell's vacation policy as spelled out in SI No. 106 substantiate that it is Pacific Bell's vacation policy to grant its employees vacation on January 1 of each year for work to be performed during the remainder of the calendar year, and not to grant its employees vacation on January 1 for work already rendered.

Having determined Pacific Bell's vacation policy, we now address GAAP and how Pacific Bell's vacation policy satisfies the disputed requirement of SFAS No. 43, that the obligation for future vacation be attributable to employees' services already rendered.

Hetler explained that Appendix A of SFAS No. 43 explicitly states that rights vesting at the beginning of the year, based on service in the preceding year, are considered to be earned

by work performed in the preceding year. This position is at variance with Pacific Bell's written instructions which state that employees earn vacation at the beginning of the year for work to be performed during that year. According to Hetler, in instances where ambiguity exists in the accounting literature, Coopers & Lybrand's local office consults with a partner in its national research group in New York.

In this particular instance, Hetler's firm did consult with the national office to confirmed that Pacific Bell's vacation policy meets the statement criteria. However, Hetler did not know what Pacific Bell documents his national office reviewed prior to expressing its opinion. Absent testimony regarding the underlying documents that Coopers & Lybrand's national office relied on, we place no weight on Hetler's opinion that Pacific Bell's vacation policy meets the statement criteria.

Contrary to Pacific Bell's position, the evidence discussed in this decision and presented in this proceeding does not substantiate that Pacific Bell's projected 1988 vacation is attributable to employees' services already rendered. Rather, the evidence substantiates that Pacific Bell's projected 1988 vacation is attributable to employees' services expected to be rendered in the future, during the remainder of the calendar year.

Irrespective of whether Pacific Bell's vacation policy meets the intended criteria of SFAS No. 43, it has never been our intention to allow a utility to recover through rates projected vacation costs prior to the time that services are expected to be rendered. DRA has substantiated that Pacific Bell's projected 1988 compensated absences expense is a projected expense for 1988 services expected to be incurred in 1988. It does not relate to vacation time that employees had built up and were due as of the end of 1987 for services already rendered. Pacific Bell has failed to carry its burden of proof in this proceeding. Therefore,

Pacific Bell's request to recover projected 1988 vacation benefits alleged to have been earned in 1987 should be denied.

Request for Finding of Eligibility

On May 9, 1991, TURN filed a request for finding of eligibility for compensation, pursuant to Rule 76.54 of the Commission's Rules of Practice and Procedure (Rules). No party has filed a response to TURN's request.

Article 18.7 of the Commission's Rules contains the requirements to be met by intervenors seeking compensation "for reasonable advocate's fees, reasonable expert witness fees, and other reasonable costs to public utility customers of participation or intervention in any hearing or proceeding of the Commission initiated on or after January 1, 1985, to modify a rate or establish a fact or rule that may influence a rate."

By its application, Pacific Bell is seeking an increase in rates due to the adoption of generally accepted accounting principles for compensated absences. Therefore, this proceeding clearly falls within the definition of applicable proceedings.

Rule 76.54 requires that a request for eligibility be filed within 30 days of the first prehearing conference or within 45 days of the close of the evidentiary record. TURN's request complies with the second option, since the evidentiary record closed on March 26, 1991.

Rule 76.54(a) requires that a request for eligibility include four items:

1. A showing that participation would pose a significant financial hardship and a summary of the party's finances. If the party has already made a showing of financial hardship in the same calendar year, the party needs only to make reference to that decision by number to satisfy this requirement.

2. A statement of issues that the party intends to raise.

3. An estimate of the compensation that will be sought.

4. A budget for the party's presentation.

Significant Financial Hardship

TURN has previously been found to have met its burden of showing financial hardship for the 1991 calendar year in D.91-05-029. Therefore, TURN has satisfied the requirement of Rule 76.54(a)(1).

Statement of Issues

In its request, TURN states that it has actively participated in this matter by addressing primarily the issues of the conformity of Pacific Bell's application with SFAS Nos. 43 and 71, and the policy impacts of Pacific Bell's application of the accounting standards.

Since the evidentiary record was closed prior to the time TURN filed its request, the issues raised by TURN and summarized in the prior paragraph are already a matter of record. TURN has satisfied the requirement of Rule 76.54(a)(2).

Compensation Estimate and Budget

TURN estimates that it may request approximately $17,900 for its participation in this proceeding, depending upon the Commission's final decision in this matter. TURN provides the following budget for its participation in this proceeding:

Attorney Fees	@ $160 per hour	$14,400
Expert Consultant	@ $100 per hour	2,500
Postage, Reproduction, and other		1,000
Total Budget		$17,900

TURN has satisfied the requirements of Rule 76.54(a)(3) and (a)(4).

Common Legal Representation

Rule 76.54(b) allows other parties to comment on the request, including a discussion of whether a common legal representative is appropriate. Pursuant to Rule 76.55, our

decision on TURN's request may designate a common legal representative. However, no party has filed any comments on this issue. Therefore, we find no current need to designate a common legal representative in this proceeding.

Summary

TURN has satisfied all the requirements for a finding of eligibility for compensation in this proceeding. TURN is placed on notice that it may be subject to audit or review by the Commission Advisory and Compliance Division and, therefore, should keep adequate accounting records and other documentation in support of all claims for intervenor compensation. Such records should identify specific issues for which compensation is being requested, the actual time spent by each employee, the hourly rate paid, fees paid to consultants, and any other costs incurred for which compensation is claimed.

Section 311 Comments

The Administrative Law Judge's (ALJ) proposed decision on this matter was filed with the Docket Office and mailed to all parties of record on August 30, 1991, pursuant to Rule 77 of the Commission's Rules of Practice and Procedure.

Comments were timely filed by DRA and Pacific Bell. Reply comments were timely filed by DRA and TURN.

We have carefully reviewed the comments and reply comments filed by the parties to this proceeding that focus on factual, legal, or technical errors in the proposed decision and in citing such errors make specific references to the record, pursuant to Rule 77.3. To the extent that these comments and reply comments required discussion or changes to the proposed decision, the discussion or changes have been incorporated into the body of this order. Comments and reply comments which merely argue positions taken in briefs, and which provide new information, not tested by cross-examination, were not considered.

Findings of Fact

1. D.87-12-063 adopted GAAP treatment for compensated absences and authorized the embedded compensated absences liability as of December 31, 1987 to be amortized over a ten-year period.

2. Pursuant to Resolution F-627 Pacific Bell filed its application with testimony on the appropriateness of recovering projected 1988 compensated absences impact in rates.

3. SFAS No. 43 requires an employer to accrue a liability for its employees' compensation for future absences if the employer's obligation is attributable to employees' services already rendered.

4. It is Pacific Bell's policy to vest its employees' vacation time on January 1 of each year.

5. Pacific Bell's employees that terminate employment on January 1 are paid the full amount of vacation vested on January 1.

6. Pacific Bell's employees that terminate employment on December 31 of the prior year are not entitled to any vacation scheduled to be vested on January 1 of the new year.

7. Those employees who remain with Pacific Bell during the entire calendar year may take the full vacation to which they are entitled any time beginning January 1 of that year. Such employees do not earn any additional vacation for that year.

8. SI No. 106 states in relevant parts that Pacific Bell grants eligibility for vacation at the beginning of the calendar year in advance of the time the vacation is actually earned.

9. Pacific Bell has no AIs that address vacation policy.

10. Contracts between Pacific Bell and employees' unions adopt Pacific Bell's vacation policy as promulgated in SI No. 106.

11. Absent testimony regarding the underlying documents that Coopers & Lybrand's national office relied on to conclude that Pacific Bell's compensated absences policy meets the disputed requirement of SFAS No. 43, no weight can be placed on its statement.

12. It has never been the Commission's intention to allow a utility to recover projected vacation cost through rates prior to the time that services are rendered.

13. Pacific Bell has failed to carry its burden of proof in this application.

<u>Conclusions of Law</u>

1. Pacific Bell's application should be denied.

2. TURN should be found eligible to claim compensation in this proceeding under Article 18.7 of our Rules.

<u>O R D E R</u>

IT IS ORDERED that:

1. Pacific Bell's request to recover $281.776 million, to be amortized over a ten-year period beginning January 1, 1988, due to increased costs associated with 1988 projected compensated absences expense is denied.

2. Toward Utility Rate Normalization (TURN) is eligible to claim compensation for its participation in this proceeding. TURN shall maintain adequate accounting records and other necessary documentation in support of any claims that it may have for intervenor compensation and make such documentation available to the Commission Advisory and Compliance Division upon its request.

3. This proceeding is closed.

This order becomes effective 30 days from today.

Dated October 11, 1991, at San Francisco, California.

JOHN B. OHANIAN
DANIEL Wm. FESSLER
NORMAN D. SHUMWAY
Commissioners

Commissioner Patricia M. Eckert, being necessarily absent, did not participate.

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

NEAL J. SHULMAN, Executive Director