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Decision 91-11-023 November 6, 1991

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ORIGINAL

In the Matter of the Application of Pacific Bell, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.	Application 85-01-034 (Filed January 22, 1985; amended June 17, 1985, and May 19, 1986)
And Related Matters. (Telesis Audit Phase)	I.85-03-078 (Filed March 20, 1985) OII 84 (Filed December 2, 1980) Case 86-11-028 (Filed November 17, 1986)

(See Decision 90-12-026 for appearances.)

I N D E X

O P I N I O N

Summary

The Commission today denies the joint motion of Pacific Bell (Pacific) and the Division of Ratepayer Advocates (DRA) to approve and adopt their proposed settlement agreement in its entirety (Agreement). We find that the Agreement is not in the public interest as it fails to refund to the ratepayers money spent, since 1990, to cross-subsidize competitive services.

Our order (D.86-01-026) set rates provisionally pending completion of staff's audit of Pacific's affiliate relationships and research activities. We anticipated that once cross-subsidies were correctly identified, rates would be adjusted accordingly. The Commission repeated this position in D.87-12-067. The settlement as crafted is inconsistent with this stated Commission policy.

Generally, we encourage use of the settlement process as a means of resolving disputes. However, this encouragement stops short of accepting agreements which are contrary to Commission policies and which do not safeguard the interests of the ratepayers. We also note that only two of the five parties to this case were signatories to the agreement; three of the five parties objected to several of its terms.

All five parties to the case supported the portion of the agreement which develops a new methodology for tracking and allocating future RD&D costs to competitive services. These new tracking procedures will safeguard monopoly ratepayers from future cross-subsidies for research, development and deployment expenses for competitive products. We recognize both the effort entailed in reaching agreement on the tracking system and the unanimous support of the parties for the new procedure. We believe it would be in

the public interest to adopt those provisions of the settlement which pertain to future treatment of product development expenses.

However, we reject the settlement because it is not in the public interest and does not refund to the ratepayers past subsidies of competitive services. We will hold hearings in this proceeding on the underlying issues to seek resolution of the following items:

1. The amount of cross subsidy both prospective and for refund including SMART Desktop;

2. How far back the refund can be calculated;

3. The disposition of the $4 million holdback; and

4. A full airing of the legal issues posed by the seeming inconsistency on the subject of refunds in D.90-05-045 and D.86-01-026 and D.87-12-067.

We do this in accordance with the Commission's Rules of Practice and Procedure (Rule or Rules) 51.7.1.[1]

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1 (Rule 51.7) Commission Rejection of a Stipulation or Settlement.

The Commission may reject a proposed stipulation or settlement without hearing whenever it determines that the stipulation or settlement is not in the public interest. Upon rejection of the settlement, the Commission may take various steps, including the following:

1. Hold hearings on the underlying issues, in which case the parties to the stipulation may either withdraw it or offer it as joint testimony,

2. Allow the parties time to renegotiate the settlement, and

3. Propose alternative terms to the parties to the settlement which are acceptable to the Commission and allow the parties reasonable time within which to elect to accept such terms or to request other relief.

DRA's Audit Report

On October 30, 1990, DRA filed its completed audit report to the Commission. DRA and its predecessor, the Public Staff Division, had been attempting to investigate the existence of any cross-subsidies of Pacific's competitive services since the onset of Pacific's 1985 general rate case.[2] Due to a number of delays (discussed further below) DRA's report was not completed until October 30, 1990.

DRA states that the primary objective of its audit was to ensure that utility ratepayers are not subsidizing competitive products and services in the areas of research, development and deployment, joint ventures, and strategic alliances. DRA made six

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2 In 1986, the Commission described the situation as follows: "Lew, who headed staff's Affiliate Audit Team, testified that the team was unable to complete its review on the reasonableness of transactions between PacBell and its affiliates because of the refusal of affiliated companies to disclose 'proprietary' informaton. ... Lew testified that his team started encountering access problems with PacBell's affiliates in September 1984. ....When asked why staff waited so long, or until March 1985, to apprise us of its difficulties, Lew said he was continually optimistic, based on repeated assurances by PacBell, that the roadblocks would get worked out.

"It is clear from Lew's prepared testimony in Exhibit 137 and his examination that he has come to be skeptical of the assurances of PacBell and/or affiliates that full cooperation is imminent....

"[4] We are perturbed by the course of events to which Lew testified. No other parties to our rate proceedings, even if they had a depth of auditing resources -- which none of them do -- undertake a thorough analysis of affiliated transactions. Of course the only means of meaningfully investigating or testing the reasonableness of such transactions is to audit both ends, at the utility and its affiliate. ... Under enabling provisions of the Public Utilities Code, we have full access to utilities' books and records, and we view impediments to our auditors as being direct impediments to our ability to regulate."

basic recommendations intended to "remedy past cross-subsidies; stop the cross-subsidies that are currently occurring; avoid the potential for future cross-subsidies; and facilitate future monitoring efforts to detect cross-subsidy." (DRA Audit Report, at iv.) The six recommendations are:

1. Pacific should be ordered to make an immediate rate reduction of $15.6 million to eliminate recovery of expenses for competitive products.

2. Pacific should refund $37 million to ratepayers for expenses incurred for competitive products since 1986.

3. Competitive products should be identified in the development stage, and ratepayers or stockholders should be allowed to recover development costs if the service is recategorized when first offered to customers.

4. Pacific Bell Directory should seek prior Commission approval to include new service offerings in the results of operations for ratemaking purposes.

5. All future development costs for products that could violate modified final judgement (MFJ) restrictions should be excluded from results of operations for ratemaking purposes.

6. Pacific should provide DRA with a periodically updated list of all projects and products and should modify its internal controls for project cost tracking and accounting.

On November 13, 1990, a prehearing conference was conducted, and hearings on the DRA Audit Report and responses were scheduled to be held over three weeks beginning on February 19, 1991, in the Commission's courtroom in San Francisco.

Pacific filed its response to the DRA Audit Report on December 21, 1990. Pacific denied that any refund or rate reduction is justified. It argued that the Commission, based on previous decisions, should dismiss all but one of the recommendations (recommendation 5, dealing with MFJ restrictions).

Pacific argued that the MFJ recommendation should be dealt with in written pleadings, rather than in hearings.

On January 17, 1991, DRA and Pacific notified all parties that they had reached a settlement. Pursuant to Rule 51.1, DRA and Pacific conducted a settlement conference with other parties on January 29, 1991. The Agreement, and a joint motion by DRA and Pacific that the Agreement be adopted and approved, were filed with the Commission on February 1, 1991.

The Agreement

DRA and Pacific have jointly moved the Commission to approve and adopt the Agreement they reached to resolve all issues connected with the DRA's prolonged audit of Pacific's ratemaking treatment of competitive products.

Under terms of the Agreement, Pacific's customers will receive an $18.8 million prospective rate reduction from the date we approve the Agreement. Additionally, Pacific will adopt new tracking and reporting procedures that will enhance DRA's ability to monitor Pacific's new product development. Under our rules, the Agreement has been distributed to and reviewed by other parties in this proceeding. All factual objections have been resolved.

Three parties to the proceeding, Toward Utility Rate Normalization (TURN), AT&T Communications of California, Inc. (AT&T), and MCI Telecommunications Corporation (MCI)[3] objected to the Agreement. MCI, AT&T, and TURN stated that the Agreement is not in the best interests of the ratepayers, arguing that a refund should be due to the ratepayers dating from January 1, 1990, when

3 MCI was not a party to this proceeding. Rule 51.4 comments are limited to parties. In its transmittal, MCI asks to be made an "interested party" for the purpose of filing its comments to the settlement. No party has objected to MCI's request. In the absence of objection, we will grant MCI's request to be made a party to this proceeding.

the cross-subsidies identified in the audit began.[4] MCI, AT&T, and TURN also raised concerns initially over the proposed methodology for tracking product development expenses. The parties objected that the Agreement began to track expenses for the development of competitive services too late in the research process. Pacific Bell and DRA amended the Agreement to address these concerns.

The Agreement, as amended by Pacific and DRA on April 24, 1991, is attached to this decision as Appendix A. Its major provisions are as follows:

1. Pacific agrees to reduce its annual rates by $18.8 million effective on the date the Commission approves the settlement.

2. Pacific agrees to exclude from annual sharing[5] calculations the revenues and development costs for products that the Commission classifies as Category III[6] and below-the-line for ratemaking purposes.

3. Pacific agrees to exclude from its annual sharing calculations product revenues and development costs for Enhanced Services

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4 The refund would total approximately $34.5 million as of November, 1991.

5 Under the new regulatory framework, when Pacific earns a return above 13%, it must "share" half its earnings above the amount with ratepayers. All earnings above 16.5% must be returned to ratepayers.

6 Category III products are competitive products that have maximum price flexibility, as contrasted with Category I products, in which prices must be approved by the Commission. See Re Alternative Frameworks for Local Exchange Carriers (1989) 33 CPUC 2d 43, 59.

products[7], if product development is discontinued before the product is offered to customers.

4. Pacific agrees to exclude from its annual sharing calculations the revenues and developmental costs for products that, after request by Pacific, are denied a waiver of an MFJ restriction.

5. Pacific agrees to provide a description of Pacific Bell Directory product development activities sufficient to provide the Commission with tracking information.

6. Pacific agrees to track capital investment and direct expenses for all new products being developed no later than at the beginning of the feasibility analysis stage of product development [as amended by proposal dated April 24, 1991].

7. Pacific agrees to provide an annual report on product development activities for products that incur $1 million or more in capital and expense.

The Agreement states further that it is a compromise of disputed issues in this Telesis Audit Phase proceeding. DRA agrees not to pursue any claim it could have raised with respect to these issues, with certain exceptions related to our review of the incentive-based regulatory framework pursuant to Decision (D.) 89-10-031.

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7 Enhanced Services are defined by the Federal Communications Commission as "services, offered over common carrier transmission facilities used in interstate communications, which employ computer processing applications that act on the format, content, code, protocol, or similar aspects of the subscriber's transmitted information; provide the subscriber additional, different, or restructured information; or involve subscriber interaction with stored information." 47 CFR 64.702.

Objections to the Settlement

Pursuant to Rule 51.4, comments contesting parts of the settlement were filed by MCI, AT&T, and TURN. Pacific and DRA replied to the comments on March 19, 1991. The assigned administrative law judge scheduled a prehearing conference on April 15, 1991. Parties were asked to present oral argument, with authorities, on the following questions:

1. Does any objection to the settlement agreement raise a contested material issue of fact, so as to require a hearing on the contested issue or issues pursuant to Rule 51.6(a)?

2. Does any objection to the settlement agreement raise a contested issue of law, so as to require an opportunity for briefs pursuant to Rule 51.6(b)?

Oral argument by all of the parties was heard on April 15, 1991.

Issues of Fact

All three parties objecting to the settlement urged that Pacific should begin tracking product development costs earlier than as specified by Section 6 of the settlement agreement. TURN acknowledged that costs "cannot reasonably be tracked the instant the light bulb appears above a researcher's head."[8] However, TURN argued that tracking can begin when a concept has developed into an identifiable product, rather than (as originally set forth in the settlement agreement) "at the latest, upon formal company authorization to begin development of a Product."

While defending their original language, Pacific and DRA at the prehearing conference, offered to amend the tracking provision to provide that tracking "will begin, at the latest, at

8 Page 12 Comments Of Toward Utility Rate Normaliztion In Opposition To Proposed Settlement, March 4, 1991.

the beginning of the feasibility analysis stage of Product development." The amendment was memorialized in a pleading dated April 24, 1991, and is included in the Agreement set forth in Appendix A.[9] All protesting parties have withdrawn their objections to the tracking provision in light of this amendment.

AT&T also criticized, as a question of fact, what it termed an ambiguity in a provision contained in Sections 2, 3, and 4 of the Agreement. The provision states:

> "If the amount of sharable earnings in any previous year, commencing with the year 1990, is changed when the Product revenue and development costs for that year are excluded, Pacific will include the amount of that change, plus interest, as a one-time Z factor adjustment in its next annual Price Cap filing pursuant to D.89-10-031."

AT&T proposed changing the first clause of the provision to read: "If the amount of sharable earnings in any one or more previous years ...". It proposed changing the last clause of the provision to add the word "negative" to "Z factor adjustment".[10] Pacific responded that the changes are unnecessary. It stated on the record at the prehearing conference that the first clause is indeed intended to cover all years for which sharable earnings would be changed, and that neither Pacific nor DRA would suggest that the clause could be construed to restrict application to only one year. Similarly, Pacific stated that the one-time Z factor

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9 The amendment is conditional. Pacific and DRA state that if hearings on the tracking issue are ordered, they reserve the right to withdraw the proposed amendment and present evidence on the tracking issue.

10 The Z factor reflects certain cost changes in a price cap index formula. See 33 CPUC 2d 43, 161.

adjustment contemplated a negative adjustment, and adding the word "negative" would be redundant.

With those assurances on the record, AT&T withdrew its objection to the provision contained in Sections 2, 3, and 4 of the Agreement. (Prehearing Conference Transcript (hereafter Tr.), p. 594.) Although there are now no objections to the settlement raising a contested material issue of fact, there appears to be some uncertainty as to what services are included in the settlement amount and what the total amount is. A hearing is required to resolve these issues.

Issues of Law

Position of TURN

The remaining objection to the Agreement is one deemed by TURN (joined by AT&T and MCI) to represent a question of law. TURN argued that the Agreement is not a reasonable[11] one if it does not address the original DRA audit recommendation that Pacific be required to make a refund to ratepayers to compensate them for their past funding of competitive products. The DRA Audit Report recommended a refund of $37 million. TURN calculated a refund based on its contention that Pacific has been wrongfully collecting $18.8 million annually since January 1, 1990, which according to TURN would result in a refund of about $25 million as of May 1, 1991.

TURN commented that the Agreement identifies $18.8 million of expenses for Pacific's below-the-line products: Voice Mail, Pacific Bell Connection, California Call Management, and SMART Desktop. The DRA Audit Report quantified costs for the first

11 Rule 51.1(e) provides:
"The Commission will not approve stipulations or settlements, whether contested or uncontested, unless the stipulation or settlement is reasonable in light of the whole record, consistent with law, and in the public interest."

three enhanced services as $15.6 million per year, but DRA and Pacific Bell have since agreed on the figure of $18.8 million per year. This amount was included in the start-up revenue requirement adopted pursuant to D.89-12-048, and is currently being charged to monopoly ratepayers as part of the Category I sharing mechanism established in D.89-10-031.

TURN argued that we expressly intended to separate the expenses for these services so that ratepayers would not be required to fund any costs connected with these products, pursuant to discussion found in D.89-10-031. TURN states:

> [T]he Commission has ordered in D.89-10-031 that Voice Mail, electronic messaging (PB Connection), and voice store and forward (California Call Management) must be treated below-the-line. The Commission reasoned that these are competitive and risky products which, if allowed to affect rates, could harm ratepayers and competitors. (D.89-10-031, slip op. at 200, 33 CPUC 2d 43, 145.) The Commission also ruled that Pacific's shareholders could retain all profits from these services. (D.89-10-031, slip op. at 201, 33 CPUC 2d at 146.) Thus, Pacific's shareholders are enjoying 100% of the profits of these services even though ratepayers will pay $25 million or more for the cost of developing these products. The bottom line is a fundamentally unfair situation: ratepayers pay the costs and Pacific's shareholders reap the profits.
>
> Precisely because of this unfairness, it is firmly established Commission policy not to allow such cross-subsidies. Countless Commission decisions state that one of the Commission's principal ratemaking goals is to avoid cross-subsidies. E.g., D.89-10-031, slip op. at 106, 315, 33 CPUC 2d at 105, 199.

TURN also emphasized that Pacific does not contest that $18.8 million of subsidy for these enhanced services is currently built into basic rates. TURN found that the burden should be on

Pacific to argue against a refund, and that, in the absence of a compelling argument by Pacific, the money collected for these services should be returned. TURN argued that the absence of a refund requirement "is inherently unjust and unreasonable" because ratepayers will have paid costs for competitive products from which shareholders get the full financial benefit. TURN, supported by AT&T and MCI, has been most forceful in pressing this issue, as its comments in objection to the Agreement succinctly demonstrated:

> "The DRA's October 30, 1990 Report resulting from that audit identified substantial cross-subsidies that have been reflected in Pacific's rates since the new regulatory framework went into effect on January 1, 1990. These cross-subsidies remain permanently embedded in Pacific's rates. Prospectively, these cross-subsidies result from the inclusion in Pacific's revenues of costs of the following competitive, below-the-line products: Voice Mail, Pacific Bell Connection, California Call Management, and Smart Desktop (hereinafter collectively referred to as 'Enhanced Services'). (DRA Report, Appendix C.) The DRA Report found these costs total $15.6 million on an annual basis. That figure has since been corrected to $18.8 million, the amount used in section 1 of the proposed settlement.
>
> "Retrospectively, the DRA Report finds that Pacific has received a cross-subsidy for the same competitive Enhanced Services since January 1, 1990 to reflect the costs of the competitive Enhanced Services. The total amount of this retrospective cross-subsidy depends on the date of the final Commission decision in this case. If the decision were issued May 1, 1991, the total retrospective cross-subsidy for the Enhanced Services would be over $25 million.
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> "The proposed settlement remedies only the prospective cross-subsidy. It quite properly requires an $18.8 million permanent rate reduction. But it fails to require Pacific to refund a penny of the approximately $25 million

> retrospective cross-subsidy for Enhanced Services...." (Footnotes omitted.)

Position of AT&T

AT&T joined other objecting parties in criticizing the Agreement for failing to address DRA's refund recommendation. However, AT&T also argued that expenses for SMART Desktop, a fourth enhanced service identified in the audit, should also be eliminated from basic rates, adding another $353,000 to the prospective adjustment, as well as increasing the refund. TURN and MCI mention SMART Desktop without attaching a dollar figure to the service. AT&T stated that without some explanation in the Agreement for not requiring a refund of enhanced services costs, the Agreement was internally inconsistent:

> However, the Settlement fails to address the recommended refund associated with Voice Mail, Pacific Bell Connection, California Call Management and SMART Desktop. Without some explanation in the Settlement for not requiring a refund of costs related to these services, the Settlement appears to be internally inconsistent, at variance with the intent of D.89-10-031, and contrary to D.87-12-067, Ordering Paragraph 36, as explained below.
>
> At a minimum, Terms 2, 3, and 4 [of the settlement] would seem to require Pacific to identify all revenues and expenses associated with these services in 1990, and to exclude them from its 1990 sharable earnings calculations and to return the improperly recovered revenues through Z factor adjustment.
>
> Further, D.89-10-031 explicitly requires that the costs associated with Category III services be recorded Below-the-Line. Pacific states that it included costs for three Category III services (Voice Mail, Pacific Bell Connection, and California Call Management) Above the Line in its 1990 Start-up revenue requirement. This appears to vary from the intent of D.89-10-031.

Finally and most importantly, in D.87-12-067, Ordering Paragraph 36, the Commission explicitly allows for a refund of these monies:

> 36. Pacific Bell's intrastate rates and charges shall remain subject to refund back to the effective date of D.86-03-049 in view of the further reductions in revenue requirements which could result depending upon the outcome of the specified issues originally reserved for Phase 2 review, to be further addressed in the next phase of these proceedings. [Emphasis added by AT&T.][12]
>
> (Footnotes omitted.)

Position of MCI

MCI's comments on the Agreement contested the declaration that the Agreement is in the public interest. MCI stated that the Agreement attempted to correct only two of the numerous problems discovered by DRA in its thorough audit. While subsequently endorsing fully the amended settlement as an appropriate resolution of future tracking of costs for competitive products, MCI remained opposed to the agreement because it failed to refund past cross-subsidies. MCI's commented as follows:

> MCI cannot conceive of any legitimate reason why the recommended ratepayer refund has been omitted from the Settlement. MCI understands that there may be some question regarding the treatment of the $16.2 million refund for Public Packet Switching for 1986 through 1989. We are also aware that the 1990 Public Packet Switching amount of $5,124 [sic] was included in the Pacific Price Cap filing. (See Appendix C of the Report). However, the remaining $15.6 million, which we understand is

12 Pages 3-5. Comments Of AT&T Communications Of California, Inc. (U 5002 C) On The Proposed Settlement Agreement Between Pacific Bell And The Division Of Ratepayer Advocates.

> now estimated to be $18.8 million, should be returned to ratepayers as a refund. Only a full refund to ratepayers for past misallocations of competitive product development costs can correct the financial harm inflicted by Pacific's mismanagement of these costs. Only a refund can sufficiently deter Pacific from further misallocations of product development costs. If the public interest is truly to be served, a refund for past misallocations must be part of the resolution of the DRA audit finding.[13]

MCI concluded by observing:

> (DRA's) audit team overcame significant obstacles to development [sic] a critical analysis of Pacific's competitive operations at a crucial time in the regulatory arena in California. With the inception of incentive regulation, the coming initiation of intraLATA competition and Pacific's recent petition to form a separate subsidiary for the provision of competitive products, the issue of cross-subsidy is of paramount importance in the regulation of Pacific.[14]

MCI therefore rejected the Agreement as an insufficient representation of the public interest.

Response of DRA and Pacific Bell

Pacific and DRA responded that TURN, as well as AT&T and MCI, mischaracterized the monetary portion of the Agreement. DRA in its Audit Report originally recommended that Pacific be required to refund $37 million and reduce rates prospectively by $15.6

13 Pages 6-7. Comments Of MCI Telecommunications Corporation (U 5001 C) To The Motion To Adopt And Approve Settlement.

14 Ibid, p. 8.

million.[15] Pacific in its response denied that either a refund or rate reduction was required, citing prior Commission decisions that Pacific said supported its financial treatment of the enhanced products in question. Pacific and DRA contended that the settling parties viewed the monetary portion of the settlement agreement as some amount between 0 dollars on the one extreme and a $37 million refund and $15.6 million rate reduction on the other extreme. DRA stated that, without abandoning any of the findings contained in its Audit Report, an $18.8 million prospective rate reduction amount in full settlement of the monetary claim, plus resolution of product development tracking and accounting procedures, served the public interest better than litigating these issues. Pacific made the same point in its responsive brief:

> "In the Settlement Agreement, the DRA and Pacific propose an $18.8 million prospective rate reduction as an inseverable component of an overall settlement designed to produce long- and short-term benefits for Pacific's ratepayers and Pacific. The rate reduction component of the Settlement Agreement was intended to resolve all monetary claims by the DRA. In its comments, TURN fails to recognize

15 The DRA Audit Report recommended an immediate rate reduction of $15.6 million. In Footnote 1 of its response to the Audit Report, Pacific on December 21, 1990, stated that it believes the correct gross revenue requirement for Voice Mail, PB Connection, and California Call Management included in Pacific's rates equals $18.8 million. While all three protesting parties in this proceeding accept $18.8 million as the correct rate reduction figure, the record in fact does not reflect a change by DRA in its rate reduction recommendation. It may be that DRA would have changed its recommendation at hearing. Conversely, it may be that Pacific's higher number was calculated with assumptions that DRA may have found unacceptable for other reasons. The point is that while the protesting parties regard $18.8 million as the proper rate reduction amount, the position of DRA on this record remains at $15.6 million.

> that the rate reduction addresses all monetary claims. Instead, TURN (as well as AT&T and MCI) seem to mistakenly conclude that the $18.8 million rate reduction settles only part of the DRA's monetary recommendations, leaving unresolved the DRA's refund recommendation for past product development costs. Contrary to TURN's suggestions, no part of the DRA's recommendations have been left unresolved.
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> "TURN and the other two parties also fail to recognize that the $18.8 million rate reduction is a negotiated resolution of these monetary issues. The Settlement Agreement was not intended to guess at what the Commission would have decided if it were presented with all of the DRA's and Pacific's evidence. Rather, the DRA and Pacific recognized that litigating the issues raised in the Audit would most likely be protracted, costly, and unlikely to effectively resolve complex, historical issues in a manner relevant to prospective cost tracking, reporting, and sharable earnings. Thus, the DRA and Pacific negotiated a resolution of these issues that not only results in reduced ratepayer rates, but also creates procedures to ensure that product development costs will be properly tracked, monitored, and accounted for prospectively in the new regulatory framework."

DRA and Pacific stated that, prior to reaching settlement, they were prepared to argue the merits of DRA's refund/rate reduction recommendations along with the other issues contained in the DRA's Audit Report. Instead, they stated, both parties concluded that the Agreement was the most efficient and equitable way to resolve all issues raised in the DRA Audit Report. They therefore argued that adoption of the Agreement was in the best interests of the ratepayers.

History of the Audit Report and of the Rate Refund Issue

It is helpful in evaluating the merits of the Agreement to examine the origin of the audit and the expressed intention of the Commission in ordering the audit.

In 1985, The Commission regulated Pacific by traditional rate of return regulation. Pacific filed its general rate case application A. 85-01-034 to adjust and update rates. One of the concerns the Commission's then Public Staff Division (PSD, now DRA) explored in the course of this application and companion investigation (I.85-03-078) was the extent to which the Commission could trace money flowing from monopoly rates to underwrite competitive services offered in some cases by affiliate companies. In D.86-01-026, which resolved many of the issues of the rate case, the Commission underscored the need to identify these cross-subsidies through audits. The Commission expressed its intention to prevent monopoly ratepayers from shouldering the expenses of providing competitive services.

> "This is our first review in any depth of PacBell's transactions with affiliates after divestiture. An excellent overview of the regulatory issues inherent in considering a utility's transactions with affiliates, and this Commission's ratemaking authority and obligations, is contained in the following California Supreme Court decisions: General Telephone Co. of California v. CPUC (1983)34 C. 3d 817; City of LA v PUC (1972) 7C 3d 331; and PT&T Co. v PUC (1962) 62 C 2d 634. We are very much concerned about ratepayer borne costs, unfair business dealings, and cross-subsidization in this case because PacBell is part of a vertically and horizontally integrated holding company, Telesis."

The Commission then concluded that staff work had not been completed, and a full record of utility activity with respect to cross subsidies was unavailable. Therefore, the Commission was unable to determine the extent of any cross-subsidies occurring at the time. The Commission stated:

> "Today we face reaching a decision on PacBell's revenue requirement without the benefit of a completed staff audit of affiliated transactions, and in our view this unfortunate

> situation was avoidable but for the posture taken by Telesis Group affiliates. We insist that our staff's audit team complete its audit in connection with this proceeding, and present any further recommendations it may have as a result. Furthermore, as a means of providing an incentive to the Telesis Group to fully cooperate, to put a price on our displeasure, and since our record is not sufficiently developed in view of the incomplete staff audit to fully find PacBell's payments to affiliates reasonable, we will reduce PacBell's gross revenue requirement by $4 million. After staff has completed its audit, and presented its results, and if we conclude further ratemaking adjustments of that magnitude are not warranted, we will restore the appropriate portion of the $4 million to PacBell's revenue requirement prospectively from the date of such a decision.

The Commission ordered rates subject to refund from January 1, 1986. The amount of the refund depended on the outcome of the audit to be addressed in the next phase of these proceedings.

Pursuant to D.86-01-026, staff proceeded with work on the audit and presented detailed recommendations during evidentiary hearings. In D.87-12-067, the Commission adopted DRA's recommended dollar adjustments in three areas (referral fee, transferred employee fee, and gain on sale of property), but declined to adopt its affiliate payment recommendations. The Commission also adopted an extensive list of DRA-sponsored recommendations designed to facilitate further review of affiliated transactions (D.87-12-067, Ordering Paragraph 34). The Commission also directed DRA to continue its audit of Pacific's joint ventures, strategic alliances, and research and development projects. (Re Pacific Bell (1987) 27 CPUC 2d 1, 140.) The Commission ordered the audit completed in three months. The Commission exhorted the parties to facilitate completion of the audit, which had been hampered by continued disputes over staff access to Pacific Bell data. In light of these acrimonious disputes the Commission held the $4

million in abeyance in an effort to provide an incentive towards resolution of the audit process. The Commission continued to order Pacific's rates subject to refund.

> "Pacific Bell's arguments [that refunds would constitute retroactive ratemaking] also ignore the fact that the rates previously approved in our interim order were rates subject to refund to account for the issues specifically reserved for Phase 2. [Among] these issues were:
>
> "6. The results of staff's completed audit of PacBell's transactions with affiliates in the Telesis, Group and staff's analysis of PacBell's San Ramon Valley Complex.
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> (D.86-01-026, mimeo, pp. 5-6)."[16]

The audit was not completed in three months because the ongoing contentious discovery disputes ultimately brought the audit investigation to a halt.[17] At a prehearing conference on

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16 27 CPUC 143 (emphasis added).

17 Discovery disputes have dogged the audit process, which bogged down after the 1987 decision because Pacific Bell, Pacific Telesis, and PacTel Corp. all asserted that many documents the audit team wished to review were protected by attorney-client privilege, and therefore, could not be produced. Alternatively, the companies claimed that other requested documents were irrelevant to the staff investigation, or concerned personnel matters which should not be disclosed in the course of this particular audit. Initially, there were almost 1,000 documents in dispute. Ultimately, through a discovery conference procedure, the number of disputed documents was reduced to approximately 300. The documents were reviewed in camera by the assigned administrative law judges who ordered production of some of the disputed documents. The companies appealed this ruling; the ruling was stayed, though eventually an informal accord was achieved and the companies provided most of the requested documents. The $4 million revenue requirement adjustment remains in place to date, pending final disposition of this Telesis Audit Phase proceeding. See Re Pacific Bell, 27 CPUC 2d at 114-15.

April 26, 1990, the parties agreed on a new six-month timetable for completion of DRA's audit. DRA filed its completed audit report on October 30, 1990.

History of Commission Decisions Regarding Certain Enhanced Services

In evaluating the merits of the settlement, the Commission can further benefit by reviewing the ratemaking treatment established for Voice Mail, PB Connection (electronic messaging), California Call Management (voice store and forward), and SMART Desktop (information services).[18]

Three pre-D.89-10-031 decisions authorized Pacific to provide certain enhanced services such as protocol conversion, voice mail, electronic messaging, and voice store and forward services (D.88-11-027, D.89-05-020, and D.89-09-049 in A.88-08-031.) Each of these decisions required Pacific to establish a separate memorandum account to track the expenses associated with the provision of these services, reserved the issue of whether these costs were to be treated above-the-line or below-the-line for a future proceeding, and stated clearly that Pacific

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18 These services are distinguished from Pacific's Public Packet Switching (PPS) service's ratemaking treatment, where we did not authorize a refund. PPS was placed above-the-line in the new regulatory framework (D.89-10-031). In that decision, we expected the ratepayers to pay the expenses and also to share in the returns from PPS sales. Five months later, D.90-05-045 recategorized the product below-the-line. The below-the-line treatment was prospective, dating from the issuance of D.90-05-045. However, unlike PPS, we never authorized above-the-line treatment for the enhanced services under discussion in the Agreement.

was not to seek ratemaking treatment of the expenses associated with the enhanced service for which authority was granted.[19]

In D.89-10-031 the Commission noted that:

> "We have granted Pacific interim authority to offer four enhanced services: protocol conversion, voice mail, electronic messaging, and voice store and forward services .... We find ... that the risks of cross-subsidy which would accompany inclusion of these services in the basic sharing mechanism could harm both ratepayers and competitive markets and further that these risks are sufficient so that these services should be excluded from the basic sharing mechanism for monopoly services.... we adopt below-the-line treatment for these four enhanced services."[20]

D.89-10-031 Finding of Fact 77 states that: "Below-the-line treatment for the four enhanced services currently authorized would maximize incentives for Pacific to compete vigorously in development of these new services and would protect both ratepayers and competitors by preventing cross-subsidies from basic services." (Id. at 218.) Conclusion of Law 35 states that "Pacific's protocol conversion, voice mail, electronic messaging, and voice store and forward services should be excluded from the basic sharing mechanism for monopoly services because there are significant risks that cross-subsidies could harm both basic ratepayers and competitive markets," while Conclusion of Law 36 states that "Pacific's protocol conversion, voice mail, electronic messaging, and voice store and forward services should be given

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19 D.88-11-027, 29 CPUC 2d 479, at 483-484; D.89-05-020, 31 CPUC 2d 591, at 597-598; and D.89-09-049, 32 CPUC 2d 445, at 453, 456-457.

20 33 CPUC 2d 43, at 145-146.

below-the-line treatment to provide a strong incentive to develop these services." (Id., at 228.) Ordering Paragraph 8 states that "[t]he incentive-based price cap regulatory framework developed in this decision and described in Conclusions of Law 23-26, 28, 29, 31-43, 50, 57-61, 65, 68, and 74 is adopted." (Id., at 223.) Thus, the Commission required shareholders, not ratepayers, to face the risks and reap the rewards of these enhanced services offerings.

Although D.89-10-031 established a comprehensive new regulatory framework, many details remained to be worked out; most critically, the Commission needed to determine the start-up revenue adjustment upon which initial new regulatory framework (NRF) rates would be based. D.89-10-031, Ordering Paragraph 14, states that: "Pacific and GTEC shall make compliance filings in I.87-11-033 no later than October 26, 1989 to implement the adopted startup revenue adjustment on an intrastate ratemaking basis .... In these compliance filings Pacific and GTEC shall: ... d. Use recorded intrastate ratemaking demand, expenses, and revenues ... for the first eight months of 1989 annualized to make the revenue adjustments." (Id. at 234, emphasis added.)

As part of its compliance filing ordered in D.89-10-03, Pacific submitted results of operations reports for the first eight months of 1989. The reports submitted were not usually used for ratemaking purposes, and included both regulated and non-regulated results of operations. Pacific adjusted these reports to take out certain expenses specifically disallowed in prior Commission decisions, but left in the enhanced services expenses. The Commission's decision adopting Pacific's start-up revenue adjustment did not delete the enhanced services expenses from Pacific's start-up revenue adjustment. Neither did the Commission approve these expenses; it did not address this issue at all.

The parties' review of Pacific's filing of the start-up revenue requirement took place during the two-week period between

October 26, 1989, when the utility compliance filings were due, and November 9, 1989, when the parties' responses to the compliance filings were due. (D.89-10-031, Ordering Paragraph 14, (33 CPUC 2d 43, at 234).) No evidentiary hearings were held but workshops took place. (D.89-12-048, 34 CPUC 2d 155, 165.) The last day of workshops was November 28, 1989. Final filings occurred three days later, on December 1, 1989. The Commissioners' own review of the start-up accounting ended December 18, 1989, the date the start-up revenue adjustment decision (D.89-12-048) was issued. The start-up decision addressed a number of serious accounting questions, but did not mention enhanced services at all.[21]

DRA's October 30, 1990 audit report found that ratepayers had been subsidizing Pacific's enhanced services steadily since expenses and capital for those services were included in the NRF start-up revenue adjustment, effective January 1, 1990.[22] DRA noted that: "This violates the Commission's intent in the new regulatory framework (D.89-10-031) which allocates all risk of competitive products to stockholders. This allocation of risk is relied upon by the Commission to prevent anticompetitive behavior and to protect captive ratepayers from cross-subsidy." (Id., at 65.) DRA recommended that the Commission order the enhanced services subsidies be refunded to ratepayers pursuant to Ordering

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21 Even if the Commission had implicitly approved the inclusion of enhanced services costs in Pacific's start-up revenue adjustment, the costs would still be "subject to refund" pursuant to Ordering Paragraph 36 of D.87-12-067.

22 Report on the Research and Development, Joint Ventures, and Strategic Alliances of Pacific Bell and Pacific Telesis Companies, pages 64-68, pursuant to A.85-01-034.

Paragraphs 27 and 36 of D.87-12-067, which made Pacific's rates subject to refund pending the outcome of the audit.[23]

Discussion

A settlement represents a negotiation of parties, each of whom prefers to settle for a known resolution of the dispute rather than risk a worse outcome through litigation. In litigation, the ultimate disposition of the claim is left to the trier of fact, whereas a settlement is a known quantity. Here, we must decide whether the Agreement is actually a better resolution of the contested issues for the ratepayers than further litigation. As such, the Agreement should represent an evenhanded compromise in which both parties have given something up, and both parties have gained something.

DRA and Pacific frame the dispute by stating that resolution of this case stood between $0 and $37 million dollars in refund, and $0 or $18.8 million/year in prospective adjustments to basic rates. Their claims are, according to DRA and Pacific, best settled by the Agreement before us.

First, we should determine the actual claims of Pacific and DRA. In DRA's audit report the recommended $37 million refund

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23 D.87-12-067, Ordering Paragraph 25 states that:

> "The auditors shall continue their audit of affiliated transactions, to review strategic alliances, R&D projects, and joint ventures, in accordance with the preceding discussion, findings of fact, and conclusions of law."

Ordering Paragraph 36 states that:

> "Pacific Bell's intrastate rates and charges shall remain subject to refund back to the effective date of D.86-03-049 in view of the further reductions in revenue requirements which could result depending upon the outcome of the specified issues originally reserved for Phase 2 review, to be further addressed in the next phase of these

disallowance included $21.3 million for Public Packet Switching (PPS). In D.90-05-045, Conclusion of Law No. 4 we stated that "Pacific should not be required to refund to ratepayers past expenditures associated with PPS services" (D.90-05-045, p. 10). However, we made no reference whatsoever to the ongoing DRA audit of joint ventures, strategic alliances, and R&D, or to the relationship of PPS services to this audit. Nor did we explicitly modify the "subject to refund" provisions of our Telesis Audit decisions to account for D.90-05-045. By ordering further hearings in today's decision, we intend to provide the opportunity for a full airing of the legal issues posed by the seeming inconsistency of these past decisions.

The DRA Audit Report's remaining adjustments were to eliminate expenses for Voice Mail, PB Connection, California Call Management, and SMART Desktop. Prior to reaching the Agreement, Pacific identified $18.8 million as the amount of expenses for the first three services currently in basic rates. This fact is in dispute which is discussed hereafter in our discussion of SMART Desktop.

Turning to the policy issues, the only issues to consider are not whether the cross-subsidy exists, but whether we are willing to overlook its prior existence. Given the fact that we have set rates subject to refund since 1986 for the specific purpose of reflecting the audit results, the essential inquiry is how far back should we hold Pacific accountable? In order to conclude that the settlement was fair and in the public interest, and that in fact the ratepayers had no claim to a refund, we would have to determine either that we meant to include the cross-subsidy in the NRF start-up revenue requirement, or that we never intended to refund any past amount.

Given the tortuous history of this audit, the impressive list of our decisions regarding the negative effects of cross-subsidies, and our repeated mandates that rates were subject to

refund pending completion of the audit, no reasonable person would conclude that we ever intended Pacific to keep these expenditures in basic rates. Can it be seriously argued that by including these expenses in the start-up revenue requirement for basic rates in 1989, and we, somehow, implicitly blessed these cross-subsidies? We think not. In adopting the start-up revenue requirement, we specified that the eight months of data should be based upon ratemaking expenses. The original decisions authorizing these enhanced services set up tracking accounts for expenses and specifically required that those expenses **not** be included in rates pending further Commission decision. There was no reason to expect these expenses to be in the start-up requirement, as the expenses were not supposed to be part of rates.

In the NRF Decision itself, D.89-10-031, we explicitly placed the enhanced services below-the-line. It does not logically follow that in the same proceeding we sanctioned the inclusion of those same expenses in basic rates. At the time of the start-up, the audit was still ongoing. Rates were still subject to refund, in case the audit should uncover misallocated expenses. The adoption of the start-up requirement did not derail or negate the audit process, and there is no explicit Commission mandate to the contrary.

Pacific and DRA claim that the Agreement resolves all monetary claims. However, the Agreement is internally inconsistent in that regard. The Agreement states that $18.8 million is the amount of the cross-subsidy. The Agreement, by reducing rates prospectively only by exactly $18.8 million, in essence declares that cross-subsidies are to be avoided in the future but were tolerated in the past. That is clearly **not** the message we have been sending to Pacific since 1986. Just because a party delays paying the taxman, does not mean the taxes are no longer due.

The history of this audit shows that we are **not** willing to overlook past cross-subsidies. The narrowly-defined goal and

object of this audit process was intended to determine the amount in question and to adjust rates accordingly.

From Pacific's perspective, it is not difficult to ascertain why the settlement is preferable to further litigation. DRA has given up any claim to almost $34.5 million of past cross-subsidies in return for Pacific's agreement to comply with the law in the future. On the other hand, it is difficult to ascertain what the ratepayers gain by agreeing to this settlement. It appears that Pacific, by successfully stalling the audit process for several years, may now avoid accountability for past years of cross-subsidies. Even though the Commission specifically made rates subject to refund so as not to reward a delaying tactic, this Agreement conveniently releases Pacific from past responsibility.

We cannot accept that this Agreement represents an appropriate resolution of the claims of the ratepayers. Pacific Bell has identified $18.8 million of cross-subsidy for Category III services which has occurred since January 1, 1990; this cross-subsidy was contrary to Commission policy past and present.

Treatment of Smart Desktop Expenses

The record in this case is not entirely clear as to the correct amount of refund due to ratepayers for all four enhanced services. Pacific has identified $18.8 million for Voice Mail, PB Connection, and California Call Management, but DRA's audit report also identifies $353,000 for SMART Desktop.[24] The report described the service as follows:

> In conclusion, DRA is recommending that expenditures of $352,920 included in the start up revenue calculation in 1989, and in the 1990

24 See Appendix C, table entitled Revenue Requirement Case Summary, in DRA's Report On The Research and Developement, Joint Venture, And Strategic Alliances of Pacific Bell and Pacific Telesis Company. October 30, 1990.

> results of operations should be excluded for ratemaking purposes. DRA believes that the studies performed to develop the concept of SMART Desktop provided clear evidence that in order to fully integrate software, data services, and business services PBD would have needed to offer as part of its integrated package, the flexibility to provide information over the public network. Although, PBD did not go forward with this project, DRA believes that there were clear indications that one of the proposed options of delivering data was the customer's use of a modem to electronically access and download data.
>
> In view of these findings, DRA is recommending that ratepayers should not bear the risk of studies and development expenditures made on service concepts, which are currently prohibited by the MFJ, or when these services are being developed on the anticipation of the information services restrictions being lifted by Judge Green.[25]

AT&T added this figure to the amount of the total refund. If AT&T is correct, inclusion of this amount brings the total refund to $19.15 million/year since January 1990. However, none of the other contesting parties referred to the SMART Desktop expenses, and DRA and Pacific did not address these specific expenses in the settlement or in their respective reply comments.

We note that in DRA's Audit Report, the original DRA recommendation for a refund of $15.6 million per year included all four enhanced services. The Commission seeks clarification of the amount of cross-subsidies in further hearings.

Resolution of TURN's Request For The Opportunity to File Briefs

In its Comments accepting Pacific and DRA's amendments to the Agreement, TURN reiterated its position that the Agreement

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25 Ibid p. 61.

contains a contested issue of law. TURN asserts that this contested issue of law, pursuant to the Commission's Rule 51.6(b), requires an opportunity for TURN and the other contesting parties to file briefs. To date, no briefing opportunity has been provided to the parties. Since we are rejecting the settlement and referring this matter to hearings, TURN's claim that it should be allowed to brief this contested issue of law under is moot.

Findings of Fact

1. In D.86-01-026, the Commission directed staff to continue and complete its audit of Pacific Bell's (Pacific's) affiliates to ascertain whether ratepayers were funding any of Pacific Telesis' (Telesis') ventures into competitive services.

2. D.86-01-026, signalling disapproval of Telesis' failure to cooperate with the staff audit, the Commission withheld $4 million from Pacific's rates pending completion of the audit of Pacific Bell's affiliates.

3. D.86-01-026, Ordering Paragraph 1, set rates subject to refund back to January 1, 1986, "in view of the further reductions in revenue requirements which could result depending on the outcome of issues to the addressed in the next phase of the proceedings."

4. In D.87-12-067, at the conclusion of the Phase Two audit, the Commission directed staff to complete an audit of Pacific's joint ventures, strategic alliances, and research and development projects.

5. D.87-12-067 continued to set rates subject to refund pending completion of issues in Phase Two, one of which was the completion of the audit of Telesis' affiliates and their joint ventures, strategic alliances, and research and development projects.

6. D.87-12-067 ordered the continuing audit completed in three months.

7. The audit was suspended in mid-1988 because of a discovery dispute over documents which were subject to attorney client privilege. The audit resumed in May 1990.

8. On October 30, 1990, DRA completed its Audit Report.

9. The DRA Audit Report made six basic recommendations intended to remedy what it alleged were past cross-subsidies, stop current and future cross-subsidies, and facilitate monitoring by the Commission and its staff.

10. The DRA Audit Report recommended that the Commission order Pacific to do the following: (i) reduce rates by $15.6 million; (ii) refund $37 million to ratepayers; (iii) identify competitive products at the development stage; (iv) seek prior approval of certain Pacific Bell Directory offerings; (v) exclude costs for projects that could violate MFJ restrictions; and (vi) modify internal controls for project cost tracking.

11. Of the $37 million refund recommended in the DRA Audit Report, $21.37 million was attributed to Public Packet Switching.

12. D.90-05-045 concluded that Pacific should not be required to refund past expenses associated with Public Packet Switching.

13. D.89-10-031 placed Public Packet Switching above-the-line. D.90-05-045 moved Public Packet Switching below-the-line and ordered no refunds.

14. When funding for Public Packet Switching is subtracted from the $37 million refund, there remains a recommended $15.6 million rate reduction in DRA's Audit Report.

15. Pacific filed its response to the DRA Audit Report on December 21, 1990 and corrected the $15.6 million figure for expenses identified in DRA's Audit Report to $18.8 million in expenses for Voice Mail, PB Connection, and California Call Management.

16. No party contests that $18.8 million is the correct figure for expenses attached to Pacific's Voice Mail, PB Connection, and California Call Management.

17. AT&T suggests in their comments that SMART Desktop expenses are not included in Pacific's $18.8 million, and should be added to the $18.8 million to arrive at the correct refund.

18. Neither DRA nor Pacific address whether SMART Desktop expenses should be added to, or are included in, Pacific's $18.8 million of expenses in their reply comments.

19. The record in this case is not crystal clear over whether the $18.8 million of Pacific's expenses includes four or only three of Pacific's services at issue in this case.

20. Pacific has denied that any refund or rate reduction is justified, and has urged dismissal of all of the DRA's Audit Report's recommendations except the one related to MFJ restrictions.

21. On November 13, 1990, evidentiary hearings in this proceeding were set for February 19, 1991, extending for approximately three weeks.

22. On January 17, 1991, DRA and Pacific notified all parties that they had reached a settlement in this proceeding.

23. Pursuant to Rule 51.1, a settlement conference for all parties was conducted on January 29, 1991.

24. On February 1, 1991, DRA and Pacific filed their settlement agreement with the Commission and moved jointly for its approval and adoption.

25. The settlement agreement, attached hereto as Appendix A, includes the following commitments by Pacific: (i) rates will be reduced by $18.8 million annually; (ii) Category III costs will be excluded from annual sharing calculations; (iii) costs for discontinued Enhanced Services products will be excluded from sharing calculations; (iv) costs for products denied an MFJ waiver will be removed from sharing calculations; (v) tracking information will be provided for Pacific Bell Directory products; (vi) expenses for all new products will be tracked at the beginning of the

feasibility analysis (as amended); and (vii) an annual report will be provided on products with costs of $1 million or more.

26. Pursuant to Rule 51.4, comments contesting parts of the settlement were filed by TURN, AT&T of California, and MCI.

27. The settling parties and the contesting parties presented oral argument on whether there were contested issues of law or fact before the assigned administrative law judge on April 15, 1991.

28. Pacific and DRA agreed to amend the settlement agreement to provide tracking at the beginning of the feasibility analysis stage.

29. All contesting parties withdrew their objections to the tracking provisions of the settlement agreement.

30. Following representations by Pacific on the record, AT&T withdrew its objections to Sections 2, 3, and 4 of the settlement agreement.

31. AT&T, TURN, and MCI continued to contest the settlement claiming Pacific should provide a refund to the ratepayers in addition to a prospective rate reduction. TURN requested an opportunity to brief that issue in TURN's Comments on the Amended Settlement.

32. TURN, MCI, and TURN objected to the alleged failure of the settling parties to address in the settlement agreement the DRA Audit Report recommendation on ratepayer refund.

33. D.88-11-027, D.89-05-020, and D.89-09-049 in A.88-08-031 established a separate memorandum account to track the expenses associated with the provision of protocol conversion, voice mail, electronic messaging, and voice store and forward services. Each of these decisions reserved the issue of whether the costs were to be treated above-the-line or below-the-line for a future proceeding, and stated clearly that Pacific was not to seek ratemaking treatment of the expenses associated with the enhanced service for which authority was granted.

34. D.89-10-031 adopted below-the-line treatment for the four enhanced services listed above.

35. D.89-12-048 which adopted the start-up revenue requirement did not mention any unique treatment intended for the four enhanced services listed above.

36. D.89-10-031 required Pacific to file an advice letter with their proposed start-up revenue requirement for basic rates under the new regulatory framework based upon "the monthly Results of California Intrastate Operations report filed with CACD in compliance with the Commission's November 5, 1979 letter. The 'Adjusted R.O. for Ratemaking,' "...Eight months of ratemaking data from their intrastate operations were included, extrapolated to indicate an appropriate one year revenue requirement.

37. DRA's Audit Report published ten months after the commencement of the January 1, 1990 revenue requirement identified expenses for four enhanced services in Pacific's start-up revenue requirement.

38. D.89-10-031, in deciding to place Pacific's voice mail, electronic messaging, and voice store and forward services below-the-line, stated that "the risks of cross-subsidy which would accompany inclusion of these services in the basic sharing mechanism could harm both ratepayers and competitive markets and further that these risks are sufficient so that these services should be excluded from the basic sharing mechanism for monopoly services."

39. The settling parties stated that the DRA Audit Report recommendation on ratepayer refund was considered part of their agreement on prospective rate reduction.

40. The Commission's policies since D.86-01-026 have stood consistently against cross-subsidies which provide no benefit to the ratepayer and are anti-competitive.

41. DRA and Pacific's Agreement is contrary to the Commission's stated policy dating back to 1986.

42. It is in the public interest to expedite this proceeding and make this order effective today.

Conclusions of Law

1. Hearing is required to consider contested material issues of fact pursuant to Rule 51.6(a).

2. Further hearings should be scheduled by ruling to address the following issues:

a. The amount of cross-subsidy both prospective and refund including SMART Desktop,

b. How far back the refund can be calculated,

c. The disposition of the $4 million holdback.

d. A full airing of the legal issues posed by the seeming inconsistency on the subject of refunds of D.90-05-045 with D.86-01-026 and D.87-12-067.

3. Further briefing is not required to consider a contested issue of law pursuant to Rule 51.6(b) since we reject the settlement and refer the matter to hearings.

4. MCI's request to be made a party to this proceeding should be granted.

5. The public policy of this state favors the adoption of settlements only when they are in the public interest.

6. The settlement of Pacific and DRA should not be considered in the public interest.

7. This order should be effective today because it is in the public interest.

O R D E R

IT IS ORDERED that:

1. The request of MCI Telecommunications Corporation to be made a party to this proceeding is granted.

2. The joint motion of the Division of Ratepayer Advocates and Pacific Bell that the Commission adopt and approve the settlement agreement attached hereto as Appendix A is denied.

3. The Commission will schedule further hearings on this matter through ruling to address the following issues:

   a. The amount of cross-subsidy both prospective and refund including SMART Desktop,

   b. How far back the refund can be calculated,

   c. The disposition of the $4 million holdback.

   d. A full airing of the legal issues posed by the seeming inconsistency on the subject of refunds of D.90-05-045 with D.86-01-026 and D.87-12-067.

4. The request of TURN for briefing to consider a contested issue of law is mooted by ordering hearings in this matter.

This order is effective today.

Dated November 6, 1991, at San Francisco, California.

PATRICIA M. ECKERT
President
JOHN B. OHANIAN
DANIEL Wm. FESSLER
NORMAN D. SHUMWAY
Commissioners

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

NEAL J. SHULMAN, Executive Director

APPENDIX A

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. (Telesis Audit Phase)	Application No. 85-01-034
And related matters.	I.85-03-078 OII 84 Case No. 86-11-028

SETTLEMENT AGREEMENT

BACKGROUND

In December 1987, the Commission ordered the DRA to perform an audit in order to examine Pacific's joint ventures, strategic alliances, and research and development projects (D.87-12-067, p. 284). When the Commission ordered the audit, Pacific operated under a traditional rate base/rate-of-return regulatory framework.

A prehearing conference was held on April 26, 1990, to determine how the audit should proceed. A schedule was established to have the DRA complete the audit and issue its report in approximately six months. The DRA and Pacific followed the schedule set forth in the prehearing conference and on November 1, 1990, the DRA filed its Report with the Commission.

The DRA's Report contained six basic recommendations: (1) Pacific should refund approximately $37 million to ratepayers for expenses incurred since 1986 for competitive products. (2) Pacific's current rates should be reduced by $15.6 million to eliminate recovery of expenses related to Category III services. (3) Potential Category III services should be identified in the development stage and ratepayers or stockholders should be allowed to recover development costs if the service is recategorized when it is first offered to customers. (4) Pacific Bell Directory should seek prior Commission approval to include new service offerings in the results of operations for ratemaking purposes. (5) All future development costs for products that could potentially violate MFJ restrictions should be excluded from results of operations for ratemaking purposes. (6) Pacific should provide the DRA with a periodically updated list of all projects and/or products and should enhance its internal controls for project cost tracking and accounting.

On December 21, 1990, Pacific filed its response to the DRA's Report. In that response, Pacific argued that the Commission, based upon its previous decisions, should dismiss all but one of the recommendations in the DRA's Report. Pacific also argued that the remaining issue, related to development activities in areas subject to MFJ uncertainty, should be handled with written pleadings, rather than hearings.

SCOPE OF THE AGREEMENT

Pacific and the DRA hereby agree to settle all claims related to or arising out of the Report and D.87-12-067 as it relates to Pacific's joint ventures, strategic alliances and research and development activities. The terms of this Agreement shall be effective upon adoption by the Commission and shall be applied only prospectively.

The terms of the Agreement set forth below shall apply only to Pacific's development of products and services to be offered to customers for a charge (collectively "Products"). The terms of this Agreement do not apply to development activities, such as network enhancements, quality improvement, or operations support system improvements, which do not result in Products offered to customers. Pacific and the DRA agree that reporting and tracking of development activities not associated with new Products will be accomplished through the Commission's ongoing monitoring mechanism.

TERMS OF AGREEMENT

1. Rate Reduction. Pacific agrees to decrease its annual rates by $18.8 million, effective on the date the Commission approves this Agreement. The decrease in rates will be implemented by increasing Pacific's existing surcredit not later than 60 days after the Commission's approval of this Agreement.

2. Sharable Earnings Treatment for Category III, Below-the-Line Products. Pacific agrees to exclude from annual sharing calculations, the revenues and developmental costs for Products which the Commission classifies as Category III and below-the-line

for ratemaking purposes. Pacific will exclude the revenues and developmental costs for such a Product in the following manner:

a. Pacific will exclude its then-current-year revenues and developmental costs for the Product in its next annual Sharable Earnings Advice Letter;

b. If the amount of sharable earnings in any previous year, commencing with the year 1990, is changed when the Product revenue and developmental costs for that year are excluded, Pacific will include the amount of that change, plus interest,* as a one-time Z factor adjustment in its next annual Price Cap filing pursuant to D.89-10-031.

3. Sharable Earnings Treatment for Discontinued Enhanced Services. For Products which, if offered, would meet the FCC's definition of Enhanced Services,** Pacific agrees to exclude from its annual sharing calculations Product revenues and development costs if Product development is discontinued before the Product is offered to customers. Pacific will exclude the revenues and developmental costs for such a Product in the following manner:

a. Pacific will exclude its then-current-year revenues and developmental costs for the Product in its next annual Sharable Earnings Advice Letter;

b. If the amount of sharable earnings in any previous year, commencing with the year 1990, is changed when the Product revenue and developmental costs for that year are excluded, Pacific will include the amount of that change, plus interest, as a one-time Z factor adjustment in its next annual Price Cap filing pursuant to D.89-10-031.

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* "Interest" as used herein is computed by using the 90-day commercial paper rate.

** Enhanced Services are defined by the FCC as: "services, offered over common carrier transmission facilities used in interstate communications, which employ computer processing applications that act on the format, content, code, protocol or similar aspects of the subscriber's transmitted information; provide the subscriber additional, different, or restructured information; or involve subscriber interaction with stored information." 47 CFR 64.702.

If disputes arise concerning whether or not a discontinued Product would have been an enhanced service, Pacific and the DRA agree to use their best efforts to informally resolve the dispute. If they are unable to resolve the dispute, the DRA may seek resolution by filing an application in the open forum investigation (I.90-02-047).

4. Sharable Earnings Treatment for Products Potentially Affected by the MFJ. The DRA raised concerns regarding Products potentially affected by the MFJ. Therefore, in addition to the procedures set forth in section 3 above, if Pacific requests and is denied a waiver of an MFJ* restriction that is required in order to provide a Product, Pacific agrees to exclude from annual sharing calculations, the revenues and developmental costs for that Product. Pacific will exclude the revenues and developmental costs for that Product in the following manner:

a. Pacific will exclude its then-current-year revenues and developmental costs for the Product in its next annual Sharable Earnings Advice Letter;

b. If the amount of sharable earnings in any previous year, commencing with 1990, is changed when the Product revenues and developmental costs for that year are excluded, Pacific will include the amount of that change, plus interest, as a one-time Z factor adjustment in its next annual Price Cap filing pursuant to D.89-10-031.

5. Tracking, Reporting, and Approval Requirements for Pacific Bell Directory. Pacific agrees to include a description of Pacific

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* Modification of Final Judgment, United States v. American Tel. and Tel. Co., 552 F. Supp. 226 (D.D.C. 1982), aff'd mem. sub nom. Maryland v. United States, 460 U.S. 1001 (1983), modified United States v. Western Elec. Co., 673 F. Supp. 525 (D.D.C. 1987), 714 F. Supp. 1 (D.D.C. 1988), affirmed in part and reversed in part 900 F.2d 283 (D.C. Cir. 1990).

Bell Directory Product development activities in the annual report on Product development described in section 7 below. Pacific and the DRA agree that the annual report on product development and the current Commission reporting and approval requirements for Pacific Bell Directory, as contained in Ordering Paragraph 7 of D.85-12-065 and as reaffirmed in D.90-09-085, are sufficient to provide the Commission with the necessary information to exercise its jurisdiction pursuant to §728.2 of the Public Utilities Code. This section 5 and section 7 below set forth all tracking, reporting, and approval requirements for Pacific Bell Directory Product development.

6. Product Development Tracking. Pacific will track, as described below, capital investment and direct expenses for all new Products being developed. In addition, if and when Pacific determines that a Product is potentially a Category III and below-the-line Product, Pacific will apply Part 64, fully loaded cost methodologies to establish the Product's costs and such costs will be recorded on an above-the-line basis. Tracking will begin, at the latest, at the beginning of the feasibility analysis stage of Product development. During the feasibility analysis stage, Pacific:

- determines feasibility, fit, and potential of the Product based on customer and company criteria (e.g., new technology, market timing, MFJ and regulatory issues);
- identifies and evaluates resources and strategies for developing the product; and
- utilizes a primary market research. [Section 6 amended April 24, 1991.]

7. Annual Report on Product Development. Pacific agrees to provide by the end of the first quarter of each year, a report describing Pacific's and Pacific Bell Directory's Product development activities during the preceding calendar year for those Products which incur $1 million or more of cumulative capital and expense. Pacific's report will include: the name and a complete functional and operational description of each Product being developed, preliminary categorization of each Product, previous year's expense and capital (by account) for each Product, current year's budget for each Product, cumulative expense and capital for each Product, and a year-to-year reconciliation to identify and describe continuing, completed, added, and discontinued Products.

8. General Provisions

a. No Admission. This Agreement is entered into in full compromise of disputed issues. 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 issues in the interest of all parties.

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

c. Inadmissibility. In accordance with Rule 51.9 of the 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.

d. Release. Provided that Pacific implements the requirements of this Agreement and except as otherwise provided in this Section 8d, 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 its Report or the joint venture, strategic alliance or research and development phase of this proceeding. The DRA or Pacific may, if necessary, readdress the process and procedures set forth in sections 2,3,4,6, or 7 of this Agreement during the Commission's review of the incentive-based regulatory framework pursuant to Ordering Paragraph 22 of D.89-10-031.

e. Obligations Imposed By Commission. Unless specifically set forth in this Agreement, neither party intends to alter or change its obligations imposed by the orders, rules, regulations, or decisions of the Commission.

f. 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.

g. 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.

h. 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.

i. 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 Agreement 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.

j. 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.

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

IN WITNESS WHEREOF, the parties execute this Agreement on this 1st day of February, 1991.

DIVISION OF RATEPAYER ADVOCATES

By: [signature]

Title: P.U. III

Date: 1 Feb 91

PACIFIC BELL

By: [signature]

Title: Senior Counsel

Date: February 1, 1991

(END OF APPENDIX A)