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Decision 92-07-072 July 22, 1992

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ORIGINAL

In the Matter of the Application of Pacific Bell (U 1001 C) for Authorization to Transfer Specified Personnel and Assets.

Application 90-12-052
(Filed December 27, 1990)

Bruce Ramsey, Attorney at Law, for Pacific Bell, applicant.
Peter A. Casciato, Attorney at Law, for Donnelley Information Publishing, Inc.; Alan Gardner and Jeffrey Sinsheimer, for California Cable TV Association; and Messrs. Armour, Goodin, Schlotz & MacBride, by Thomas J. MacBride and Barbara L. Snider, Attorneys at Law, for MCI Communications, Inc.; Protestants
Randolph W. Deutsch, Attorney at Law, for AT&T Communications of California, Inc.; Messrs. Jackson, Tufts, Cole & Black, by Joseph S. Faber, Attorney at Law, for California Bankers Clearing House Association/The County of Los Angeles; Messrs. Graham & James, by Martin A. Mattes, Attorney at Law, for California Pay Phone Association; and Preston Mike, Attorney at Law, for the City of Los Angeles; interested parties.
Rufus G. Thayer, Attorney at Law, and Charles Christiansen, for the Division of Ratepayer Advocates.

INDEX

Subject	Page
OPINION	2
I. Summary	2
II. Application of Pacific	3
III. Procedural Background	5
A. Protests	5
B. Motion of Pacific Bell to Place its Valuation of Assets Under Seal	6
C. Affiliate Transaction Guidelines	7
D. Evidentiary Process	9
E. Motion of Pacific to Strike Portions of CCTA's Briefs	9
F. Comments on ALJ's Proposed Decision	11
1. DRA	12
2. CCTA	12
3. Pacific	12
IV. Discussion	15
A. Background	15
1. Genesis and Development of ISG	16
2. Designation of Enhanced Services as Category III Services	17
3. Cost Allocation for Enhanced Services	17
4. Affiliate Transaction Rules	18
B. Incentives Created by Transfer of Category III Services to Affiliates	20
1. Ratepayer Interests	20
2. Shareholder Interests	21
3. Intervenor Interests	21
C. Reasonableness of Structural Separation	21
D. Valuation of Assets Transferred	22
E. Fees for Specific Transactions Between Affiliates	23
1. Twenty-Five Percent Employee Transfer Fee	23
2. Thirteen Percent Referral Fee	24
3. Cost Allocation	26
a. Continued Use of Transfer Pricing	26
b. Need for Market Price Studies	27

Subject	Page

4. Pricing Pacific's Nontariffed Services to PBIS 30
   a. PBIS Use of Proprietary Information 31
   b. PBIS Use of Intellectual Property . 33
   c. Offer of Services to Third Parties 33
5. Pricing PBIS Services to Pacific 34

F. Implementation and Enforcement Issues 36
1. Regulation of PBIS as a Telephone Utility 36
2. Tariffing PBIS Services 36
3. Accounting and Reporting Requirements . 39
4. Ratemaking Adjustments 40
   a. Transfer of ISG Below the Line 40
      i. Cost of Service 41
      ii. Assets in Rate Base 42
      iii. Difference Between Going Concern Valuation and Net Book Value 43
      iv. Valuation as a Going Concern 45
      v. Reliance on Pacific's Internal Business Case 47
   b. Transfer of ISG to PBIS 48

V. Conclusion 48

Findings of Fact 49

Conclusions of Law 58

ORDER 59

OPINION

I. Summary

On December 27, 1990, Pacific Bell (Pacific) filed the instant application to transfer the personnel and assets of its Information Services Group (ISG). ISG is a department within Pacific that provides enhanced services. These services currently consist of voice mail, electronic messaging, voice store and forward services, and fax store and forward services. The personnel and assets of ISG would be transferred to Pacific Bell Information Services (PBIS), a newly created California corporation. This application is made under Public Utilities (PU) Code § 851.[1]

The application is approved, subject to Pacific's compliance with the Commission's existing affiliate transaction guidelines and our interpretation of those guidelines herein. We affirm that any amendments to the Commission's affiliate transaction guidelines in this decision are to be applied specifically to the ISG/PBIS transfer and not generically to all utility-affiliate transactions. However, we clarify that for all utility-affiliate transactions "full cost" as it appears in the transfer pricing rule and affiliate payment rule (see Decision (D.) 86-01-026) means fully allocated cost as defined by Part 64 of the

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1 PU Code § 851 states:

> "No public utility...shall sell, lease, assign, mortgage, or otherwise dispose of or encumber the whole or any part of its...system, or other property necessary or useful in the performance of its duties to the public,...without first having secured from the commission an order authorizing it so to do...."

regulations promulgated by the Federal Communications Commission (FCC) (47 CFR §§ 64.901, 64.902) and modified by this Commission.

II. Application of Pacific

Under the new regulatory framework (NRF) adopted by D.89-10-031 (the "NRF decision") in Investigation (I.) 87-11-033, the services which are the subject of this application have been designated "Category III" services.[2] Accordingly, the costs and revenues from the subject services should be recorded below-the-line; that is, they are not revenues subject to the NRF shareholder/ratepayer sharing mechanism.

PBIS was incorporated on November 1, 1990. Pacific proposes to transfer substantially all of the current personnel and assets that are directly involved with these services to PBIS in exchange for all PBIS stock. As a result, PBIS would be wholly owned by Pacific. PBIS's expenses, losses, and future gains would accrue directly to Pacific's shareholders. Its net revenues would be paid to Pacific as dividends. These dividends would accrue below the line so that PBIS earnings would flow directly to Pacific's shareholders.

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2 The NRF decision placed services which were detariffed due to statutory requirements or federal preemption in Category III. In People of the State of California v. FCC, 905 F. 2d 1217 (9th Cir. 1990), the U.S. Court of Appeals overturned the FCC's order preempting states from tariffing enhanced services. Category III services include the four authorized enhanced services. They are excluded from the revenue sharing mechanism because the Commission found that the inclusion of these services in the basic sharing mechanism would create a significant risk of cross-subsidy which could harm both ratepayers and competitive markets. Because of the riskiness of enhanced services and the potential societal benefits from these services, the Commission adopted below-the-line treatment for enhanced services. (D.89-10-031; 33 CPUC 2d 43, 146.)

Pacific highlighted the following regulatory issues in its application:

1. Pacific maintains that its proposed below-the-line treatment of PBIS's earnings and losses would not adversely affect ratepayers, since the involved services are Category III services and would continue to be treated below the line.

2. Pacific values the assets to be transferred at the adjusted net book values of the tangible assets used by ISG, such as operating leases (buildings, furniture, and office equipment), switching equipment, and computers.

3. Pacific characterizes the transfer as a transaction between nonregulated affiliates, for which no transfer fee is required. Pacific seeks a waiver of the 25% employee transfer fee required by Ordering Paragraph 24 of the decision that established affiliate transaction rules for Pacific ("affiliate transaction decision," D.87-12-067; 27 CPUC 2d 137) because the personnel are involved with services that were placed below the line by the NRF decision.

4. Pacific proposes that the allocation of common costs between PBIS and Pacific be determined under the adopted affiliate transaction rules instead of the currently used FCC Part 64 cost allocation rules since the assets, personnel, and operations formerly attributed to ISG will belong to a separate corporation.

5. Pacific intends to provide the same nontariffed goods and services to PBIS as it has provided to ISG. There are 48 such items. Some of the more substantial services are the joint marketing of regulated and nonregulated services by Pacific employees, order processing by Pacific service representatives, service and repair by Pacific employees, planning and development of enhanced and noncommunications services prior to public offering

of the product, and gateway services.[3] Additional nontariffed services include corporate services which are also provided to other nonregulated Pacific affiliates, such as consultation on capital recovery, central office space, corporate communications, loaned employees, training, human resources (benefits), legal services, and regulatory support.

III. Procedural Background

A. Protests

Pacific's application was protested by MCI Telecommunications Corporation (MCI) and Donnelley Information Publishing. These protestants argued that hearings were needed to implement safeguards to ensure that competing enhanced services providers are not disadvantaged by Pacific's proposed affiliate. In addition, the Commission's Division of Ratepayer Advocates (DRA) protested the application because Pacific failed to provide the agreed price and terms of payment for the ISG assets in its application.

Telephone Answering Services of California, Inc. stated it would not oppose the application if PBIS would comply with any restrictions on the joint marketing of basic and enhanced services and the use of Customer Proprietary Network Information (CPNI) that arise out of Phase II of Application (A.) 89-12-010 or the Commission's anticipated Investigation into enhanced services.

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3 Pacific describes gateway services as information transmission services that employ computer applications and involve subscriber interaction with stored information together with protocol conversion.

B. Motion of Pacific Bell to Place its Valuation of Assets Under Seal

Pacific referenced its valuation of assets to be transferred as Exhibit B to the application. However, the valuation was omitted from the publicly available application; it was provided only to the Commission Advisory and Compliance Division (CACD) and DRA staff. Concurrent with the filing of its application, Pacific moved to place its valuation under seal. In support of its motion, Pacific stated that the valuation is confidential and proprietary, and that release of the document to Pacific's competitors would place Pacific at an unfair business disadvantage and cause irreparable harm to Pacific's information service operations.

DRA opposed Pacific's motion because, according to DRA, the materials do not contain trade secrets or marketing strategy information and thus, disclosure would not place Pacific at a competitive disadvantage. DRA also cited Rule 35 of the Commission's Rules of Practice and Procedure (Rules) as authority for its position.[4]

The administrative law judge (ALJ) properly denied Pacific's motion at the first prehearing conference. Pacific could not specify the competitive harm it might suffer as the result of disclosure. Since Pacific proposed to value its transfer of assets at the higher of adjusted net book value or current market value, it placed the valuation squarely before the Commission as an issue of fact. The public interest in an open and full evidentiary

4 Rule 35 (b) requires applications under § 851 to contain a description of the property involved in the transaction, and if the transaction is a sale or assignment, a statement of the book cost and the original cost, if known, of the property involved; Rule 35 (d) requires disclosure of the agreed purchase price and terms of payment.

hearing clearly outweighed Pacific's vague assertions of potential harm. We are disappointed that Pacific would frivolously move to protect materials that so clearly failed to merit confidential treatment.

C. Affiliate Transaction Guidelines

A prehearing conference was held on March 19, 1991. At that time, the ALJ granted parties' requests to have Pacific circulate the affiliate transaction rules it intended to observe with respect to dealings between Pacific and its PBIS subsidiary. Pacific distributed "Pacific Telesis Group's Affiliate Transaction, Policies, Guidelines and Reporting Requirements" (Telesis Guidelines).

These guidelines were based on Commission decisions concerning affiliate transactions, discussed in more detail below, and had been reviewed by CACD and DRA before finalization. In its transmittal letter, Pacific stated that it intended to revise the Telesis Guidelines to carry out the Commission decision defining Category III services (discussed below). In response to parties' criticism that the Telesis Guidelines failed to address specific Category III concerns, Pacific responded that the Telesis Guidelines should not be reexamined or modified because they reflect all affiliate transaction rules adopted by the Commission. Pacific urges the Commission to ratify the Telesis Guidelines and to authorize Pacific to apply those guidelines to its transactions with PBIS, subject to the exceptions specified in the instant application.

Pacific has admitted that the Telesis Guidelines fail to implement portions of the Commission's decision placing Category III services below-the-line. The ISG department which is the subject of this application is a Category III service and would operate below-the-line as a Pacific subsidiary. It is appropriate, therefore, to require Pacific to revise the Telesis Guidelines to incorporate the terms and conditions of its transactions with an

affiliate that provides Category III services. The resulting rules will be known as the Pacific/Category III Affiliate Guidelines. These guidelines must incorporate the rules for transactions between Pacific and PBIS adopted by this decision.

The ALJ agreed with the parties that the rules adopted in this decision, insofar as they addressed the particular circumstances of this transfer, would be applied solely to the transfer of ISG to PBIS. It was their intent that no new rule or affiliate transaction rule specifically tailored to PBIS should be applied generically to subsequent transactions between Pacific and its affiliates.

Upon review of the facts and the arguments, we find that this decision simply affirms existing Commission rules for utility/affiliate transactions. The only item which could be construed as specific to this application is the method for valuing the asset. Here, we are valuing ISG as a going concern. The reason, explained further below, is that ISG has been developed since 1984 using the utility's base rate revenues. It was only in the last two years that ISG was designated as a below-the-line department. ISG became a going concern through ratepayer funding. This cannot be said for every asset that Pacific may subsequently transfer to a subsidiary. Therefore, while we affirm that the asset must be valued at its fair market value, we clarify that valuation of the asset as a going concern may not be required in every case under our affiliate transaction rules.

With this sole exception, we find that every other term set forth in this decision concerning the transfer of ISG to PBIS and governing subsequent transactions between Pacific and its PBIS subsidiary should be incorporated in generic Pacific/Category III Affiliate Guidelines. Accordingly, Pacific should be ordered to revise the Telesis Guidelines to incorporate all of the these terms. Appendix A of DRA's Opening Brief provides a concise summary of the affirmed terms and should be referred to in

conforming the Pacific/Category III Affiliate Guidelines to this decision. Once reviewed and approved by CACD, the Pacific/Category III Affiliate Guidelines will govern the transfer of goods and services between Pacific and its subsequent Category III affiliates.

D. Evidentiary Process

At the prehearing conference, California Cable Television Association (CCTA) was granted leave to file a late protest. The ALJ also asked Pacific, DRA, and any other interested party to propose a joint statement of the Commission's affiliate transaction rules that would apply to dealings between Pacific and PBIS. Despite repeated attempts, Pacific and DRA were unable to stipulate to any definitions or rules to govern the proposed transfer of assets.

Evidentiary hearings were held September 5 through September 12, 1991 in San Francisco. The matter was submitted upon receipt of concurrent opening and reply briefs on October 22 and November 5, 1991, respectively. Briefs were submitted by Pacific, CCTA, the California Banker's Clearing House Association/County of Los Angeles (CBCHA), and DRA.

E. Motion of Pacific to Strike Portions of CCTA's Brief

In its opening brief, CCTA requested the Commission take official notice of two events which occurred after the conclusion of evidentiary hearing. One was the removal of the prohibition on the Telesis companies' provision of full-scale information services by the U.S. District Court for the District of Columbia in July of 1991. (U.S. v. Western Electric Co. (D.D.C. 1991) 767 F. Supp. 308.) The other was the issuance by the Public Utilities Commission of the District of Columbia (D.C. PUC) of proposed rules to govern affiliate relationships such as the one under review here. On the basis of these events, CCTA asked in its opening brief that "the D.C. PUC proposal be seriously considered as adding

elements toward a long term solution in this proposed transaction...." In its reply brief, CCTA argued that recent events governing the Modified Final Judgment mandate PBIS be limited to the four identified enhanced services until a further hearing can be held and that the hearing be reopened for additional evidence on the "new issues" raised by the two regulatory events. CCTA also attached "final proposed supplemental rules" to its reply brief.

Pacific moved to strike the D.C. PUC decision, CCTA's arguments, and the affiliate transaction guidelines newly proposed in CCTA's briefs. Pacific claimed that CCTA's proposal of affiliate transaction rules for the first time in its briefs effectively denied Pacific its due process rights because Pacific had no opportunity to cross-examine CCTA or to rebut CCTA's proposed rules. CCTA replied that the motion was untimely, Pacific had countered CCTA's position in its reply brief, and that the Commission must be made aware of national developments.

At the close of evidentiary hearing in this case, the ALJ asked the parties to list in their briefs only those transaction guidelines that had previously been discussed in testimony. The briefs were not intended as a vehicle for introducing new guidelines, since the parties would have no opportunity to challenge the reasonableness of those guidelines through cross-examination. Given the ALJ's specific ruling, it would be inappropriate to admit over Pacific's objection CCTA's newly proposed transaction guidelines.

For similar reasons, we strike references to proposed rules of the D.C. PUC. With regard to the recent decision of the D.C. District Court, we expect to undertake a generic examination of utility provision of enhanced services. CCTA may bring these matters to our attention in that context. Pacific's motion to strike portions of CCTA's opening and reply briefs is granted.

F. Comments on ALJ's Proposed Decision

On May 7, 1992, the ALJ's proposed decision was filed and served on the parties pursuant to § 311 of the PU Code as implemented by Rule 77.1 et seq. of the Commission's Rules of Practice and Procedure (Rules). On June 5, 1992, comments were filed by Pacific, DRA, and CCTA. On June 12, 1992, reply comments were filed by Pacific, CCTA, and CBCHA/County.

CCTA's reply comments included a motion to strike Pacific's comments for failure to conform to the criteria defined by Rule 77.3 Scope of Comments. CCTA asserts that Pacific's comments do not contain the detailed citations to the evidentiary record required to support Pacific's proposed changes to the ALJ's decision and that Pacific's ex parte briefing materials are new materials that are not a part of the record in this case; as such, those materials misrepresent the record in violation of Rule 1.

We note that while Pacific's comments do provide some reference to the transcript for its own propositions, Pacific's comments do not consistently make specific references to the record in citing "factual, legal, or technical errors" as required by Rule 77.3. Most of this shortcoming is due to the fact that most of Pacific's "311 comments" constitute reargument of the position Pacific took in its brief. Such reargument is expressly disallowed by Rule 77.3 and will be accorded no weight.

As to Pacific's use of ex parte briefing materials, those materials are not matters of record and assertions contained therein will not be considered in the decision-making process (Rule 1.2, The Record). We caution all parties that this exclusion does not free parties to mislead the Commission by an artifice or false statement of fact or law in violation of Rule 1, Code of Ethics.

In this case, we agree with CCTA that those materials contained new theories and argument that Pacific had not advanced on the record. However ill-founded those arguments may be, we do not discern an intent to mislead the Commission. Rather than

strike all of Pacific's 311 comments, we will disregard those comments which merely constitute reargument or introduce new assertions which were not made on the record. Therefore, we decline to grant CCTA's motion.

1. DRA

We will incorporate the technical modifications proposed by DRA. Specifically, certain references to FCC Part 64 will now include the phrase, "as modified by the Commission." This clarifies the fact that the Commission uses a slightly modified version of the FCC allocation rule. We will also adopt DRA's suggestion to calculate interest according to a 90-day commercial paper method. Finally, we will adopt the proposed 180-day time limit to complete market pricing studies. This time limit will begin running after the aggregate billing for the service in question reaches its $100,000 threshold.

2. CCTA

We disregard the majority of CCTA's comments for the reasons cited above. However, with regard to their request that we declare PBIS a telephone company pursuant to PU Code §§ 433 and 434, we expressly decline to make such a classification at this time, without prejudice to our continuing jurisdiction to consider the issue in the context of a broader proceeding. This issue would be addressed more properly in a generic proceeding which affords interested parties such as existing voice mail providers an opportunity to be heard on the question of the Commission's jurisdiction over them.

3. Pacific

The comments submitted by Pacific were particularly troublesome. They constituted reargument, which added nothing to the record, and diverted our resources from other substantive matters. However, because Pacific's arguments are based on a misguided interpretation of the issues in this proceeding, we will provide the following clarification.

Pacific objects to valuing ISG as a going concern. The adopted method for estimating the value of ISG as a going concern uses the future economic benefits derived from ownership of the business as the measure of value. Pacific claims this method will confer the future profits of ISG upon ratepayers, contrary to the Commission's intent in D.89-10-031. In fact, going concern valuation is being used to establish the current value of ISG; it is not an assignment of future profits to ratepayers.

Even assuming that valuation under the going concern methodology confers future profits upon ratepayers, such a result would not be inconsistent with D.89-10-031. Pacific cites a portion of the Commission's NRF decision D.89-10-031 stating that use of ratepayer funds does not automatically give ratepayers an ownership interest in any subsequently developed service. This language is irrelevant to our decision. As in other proceedings involving the conveyance of utility rate base property, the issue of who owns the utility property providing utility service has become a red herring.

> "...(O)wnership alone does not determine who is entitled to the gain on the sale of the property providing utility service when it is removed from rate base and sold.
>
> ". . . We note that utility shareholders must also base their claim to the gain on sale of rate base assets on grounds other than property ownership." (D.90-11-031, Order Mod. D.90-04-028 and Den.Rhrg. in Application of Southern California Gas Company for Authority to sell and lease back its Headquarters Property.)

Pacific asks us to believe that in 1984 shareholders voluntarily assumed the risk of financing the development of voice mail, which was used as a part of utility operations in 1988, even before the NRF decision expressly created the enhanced services category and placed it below the line in October of 1989. That is not plausible. The more likely scenario is that until ISG was expressly

moved below the line, ratepayers funded all above the line activities and development. Pacific has not satisfactorily disproved this inference.

Our decision to use going concern valuation is not premised on any finding that either shareholders or ratepayers have an ownership interest in ISG. By funding development of ISG, ratepayers have borne the risks of developing ISG as an operating division within the utility. Pacific noted in its comments, it is our policy that reward should follow risk. Ratepayers will be compensated for this risk by the valuation of ISG as a going concern.

Pacific also expresses concern that any reimbursement for ISG development awarded from this proceeding may result in a double recovery of research and development funds by ratepayers. This concern arises because the Commission is attempting to establish the amount of ratepayer funding used to develop several enhanced services, including ISG in another proceeding (A.85-01-034). Indeed, we approve a settlement in that case today. On the other hand, the decision to value ISG as a going concern is based on a good record developed in this proceeding. Because the amount of double-recovery, if any, is unclear from the current record, we invite Pacific to file a petition of modification of this decision if it believes there is any double counting.

We have considered Pacific's comments on the definition of "full cost" pricing and are of the opinion that they warrant no change to the ALJ's proposed decision that the term "cost" should be defined as "fully allocated cost."

The pertinent language is, "While Part 64 rules require that such services be priced at fully allocated costs, Commission policy is for the utility to price its nontariffed services provided to an affiliate at the higher of cost or market value. We will maintain current Commission policy in this regard." (33 CPUC 2d at 149.) Pacific asserts that there is some essential difference between Pacific's term "full cost" and the Part 64 term "fully allocated cost" but cites no decisional language to support this distinction. Indeed, Pacific has never provided its definition of full cost on the record.

In fact, there is no difference. In the cited statement, the pertinent modification to FCC Part 64 is not the definition of cost, but rather the inclusion of the Commission's policy of pricing services at the higher of either cost (fully allocated cost) or market price. Since this clarification is not a substantive change in our pricing methodology, Pacific's due process rights will not be affected.

Finally, Pacific challenges our decision to require tariffing of PBIS services. We agree that this issue is problematic. However, PBIS is not a fully independent entity. Pacific and its affiliate will share marketing services, proprietary information, and intellectual property. Granted, both companies will be required to pay for each other's services, but the ramifications of allowing a regulated utility with significant market power to engage in this kind of sharing are not lost on us.

Because of the arrangement between PBIS and Pacific, the public interest would not be supported by foreclosing the tariffing issue. We do not address PBIS's status as a utility at this time. That subject has not been adequately litigated in this proceeding. However, because of Pacific's status as a regulated utility, under § 701 of the PU Code we may condition our approval of the PBIS transfer on the requirement that PBIS file tariffs.

We are sensitive to Pacific's competitive concerns, but we cannot abdicate our responsibility to the public interest. Furthermore, there is every indication that tariffing of PBIS might be a temporary situation. Minor additions to the decision have been made to reflect these concerns.

IV. Discussion

A. Background

Before applying the Commission's rules to Pacific's proposed transfer of assets and personnel, it will be helpful to describe Pacific's existing ISG, its context within the new regulatory

framework, and the flow of benefits that would appear to result from the transfer.

1. Genesis and Development of ISG

Pacific's marketing department began development of enhanced services in 1984. In 1988, Pacific formed ISG as a result of the U.S. District Court's March 7, 1988 decision that authorized the Regional Bell Operating Companies (RBOCs) to provide certain enhanced services.[5] ISG is a strategic business unit within the marketing department. Voice mail, electronic mail, voice store and forward, and fax store and forward are enhanced services currently approved to be offered by ISG.[6]

ISG manages voice mail services for Pacific. The utility is planning to retire the existing voice mail system and have ISG, or its successor, PBIS, provide a more modern and versatile voice mail system. The system to be phased out is in Pacific's regulated accounts. This means the depreciated capital investment will be taken out of rate base and Pacific should not earn a rate of return on the removed investment.

Under the proposal, Pacific would pay PBIS the "list price" for voice mail and other enhanced services. Pacific expects to

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5 The costs for developing ISG costs were included in Pacific's test year 1986 general rate case, since they were not excluded in any related work papers or Commission decisions. When the Commission adopted the NRF, the start-up revenue requirement was not adjusted to remove the costs incurred for the enhanced services from 1984 through the first eight months of 1989.

6 During 1988-89, Pacific obtained FCC approval for its comparably efficient interconnection (CEI) plans to provide voice, electronic or "e"-mail, and voice store and forward. During that period, Pacific also obtained CPUC approval to provide voice mail and protocol conversion services (D.88-11-027), electronic messaging services (D.89-05-020), and voice store and forward services (D.89-09-049). In 1990, Pacific's market trial of fax store and forward was approved by the FCC. By D.90-07-052, as modified by D.91-04-072, Pacific was granted interim authority to offer fax store and forward service and was required to tariff this service.

receive a discount from list price based on factors such as the volume of its demand or an extended term of contract. According to Pacific, the price actually paid would be market-based.

2. Designation of Enhanced Services as Category III Services

As noted above, the NRF decision required below-the-line treatment for the four then authorized enhanced services effective January 1, 1990, concurrent with the adoption of the NRF. Under this treatment "shareholders bear all risks but also retain all profits from these services." (33 CPUC 2d at 60.) Unfortunately, Pacific did not place ISG below the line.

The Commission decisions authorizing Pacific to provide enhanced services required it to establish a separate memorandum account to track the expenses associated with the provision of these services. Those decisions held that Pacific was not to seek ratemaking treatment of the expenses associated with the enhanced services. Enhanced services were clearly designated as below-the-line services.

3. Cost Allocation for Enhanced Services

In the NRF decision, the Commission adopted a cost allocation methodology to segregate the costs of Category III services so that they could be excluded from the monopoly utility's net revenues, i.e., be placed below the line. The adopted methodology uses fully allocated embedded costs based on the FCC's Part 64 rules, except in one important respect. Part 64 requires that the service be priced at fully allocated cost, while this Commission's policy requires the utility to price its nontariffed services to an affiliate at the higher of full cost or market value.

In Pacific's test year 1986 general rate case, A.85-01-034 et al., DRA sought to determine whether there existed cross-subsidies of Pacific's competitive services. The Commission's recent decision in this matter summarized the accounting and ratenaking treatment of ISG services since the

implementation of the NRF (D.91-11-023, "R&D (research and development) decision").

The R&D decision recounts that upon the adoption of the NRF, the Commission had to establish the January 1, 1990 start-up revenue requirement as a basis for post-NRF rates. Pacific submitted a compliance filing which included the results of operations, i.e., capital costs and expenses, for the enhanced services. The Commission did not address the inclusion of enhanced services in its start-up revenue decision; thus, the costs and expenses of enhanced services were included in the start-up revenue requirement by default.

Pursuant to its audit in A.85-01-034, DRA had recommended the Commission make certain revenue adjustments. However, DRA and Pacific subsequently reached agreement on these and other audit issues and tendered a settlement agreement for Commission approval in A.85-01-034.

The ALJ in this transfer proceeding ruled that the compensation to ratepayers for any revenues improperly included in the start-up revenue requirement would be determined in A.85-01-034, et al., and not in this proceeding. Nonetheless, our action in this proceeding must be consistent with our holding in the R&D decision. There, we rejected the settlement because it "...does not refund to the ratepayers past subsidies of competitive services" and is not in the public interest (D.91-11-023, mimeo. p. 3).

Our handling of this case will be consistent with our findings in D.91-11-023 that ratepayers have funded the development of competitive services in the past and that the ISG cost of service was not placed below the line when Pacific's NRF start-up revenue requirement was adopted.

4. <u>Affiliate Transaction Rules</u>

The affiliate transaction rules that govern the instant proposal appear in two decisions. D.86-01-026 (20 CPUC 2d 237),

the first decision to adopt a revenue requirement for Pacific after its divestiture by American Telephone & Telegraph Company, established rules for pricing services billed to Pacific's affiliates (transfer pricing rules). D.86-01-026 also established standards for payments made by the utility to its affiliates (affiliate payments).

In its second decision in Pacific's test year 1986 general rate case, D.87-12-067 (27 CPUC 2d 1), the Commission set the premium payable by affiliates to a local exchange company (LEC) when hiring employees from the utility at 25% of the transferred employee's starting salary with the affiliate. The Commission also adopted a 13% premium payable by affiliates to the LEC when a sale results from a customer referral by the utility. The reporting and accountability standards required as a condition of approval of San Diego Gas & Electric's application to form a holding company were affirmed for Pacific and its affiliates as well.

D.87-12-067 is particularly relevant to this proceeding because it announces a "ratepayer indifference" standard for analyzing the reasonableness of affiliate transactions. The Commission stated:

> "...(W)e think it is appropriate to state certain fundamental principles that we will use regarding affiliate issues.
>
> "First, we are determined to make the ratepayer indifferent to the formation of a holding company type of organization as well as to the operations of any affiliates or subsidiaries. Our objective is to provide the mechanisms that will ensure this ratepayer indifference. It therefore follows that a utility and its ratepayers must be compensated for any flow of actual resources or benefits to an affiliate...."

B. Incentives Created by Transfer of Category III Services to Affiliates

1. Ratepayer Interests

The NRF decision specified that enhanced services should be accounted for below-the-line. The proposed transfer of the enhanced service function to an unregulated utility subsidiary would continue this treatment. However, the protection afforded Pacific's ratepayers and competitors by the Category III treatment of these services could be slightly diminished under the specific circumstances of this transfer. A below-the-line division within an RBOC must be imputed with fully allocated cost under D.89-10-031. However, an affiliate of Pacific must compensate the utility at the higher of either full cost or fair market value. "Full cost" was not specified to be fully allocated cost. Under Pacific's interpretation of the affiliate transaction rules, when that cost exceeds market value the division could avoid payment of common costs such as corporate overhead by becoming a separate corporate affiliate.

Under Pacific's proposal, the monopoly utility would be a significant purchaser of PBIS services. If PBIS charged Pacific an unfairly high rate, ratepayers would be adversely affected because Pacific would experience greater costs and fewer net revenues would be available to reach the sharings threshhold.[7] Shareholders, on the other hand, would be indifferent to the decrease in sharable

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7 The NRF decision established a sharing mechanism as part of the NRF. All utility earnings in excess of a specified "benchmark" rate of return and less than a specified "cap" rate of return are to be shared 50-50 between shareholders and ratepayers. This mechanism, when coupled with the imputed productivity factor, was intended to ensure that ratepayers receive a portion of the expected benefits of incentive regulation while preserving strong efficiency incentives. (33 CPUC 2d 43.)

earnings because the profit from PBIS operations would accrue directly to them.

2. Shareholder Interests

Conversely, the Commission must ensure that PBIS, the subsidiary, is in fact paying a fair price for services it procures from Pacific, the monopoly utility. The lower cost of service may enable Pacific's shareholders to earn a profit on PBIS operations, but if the price is too low to allow Pacific to recover its costs, this may prevent Pacific's monopoly operations from realizing earnings that would otherwise be shared with ratepayers.

3. Intervenor Interests

PBIS's competitors fear that revenues from the monopoly utility will enable PBIS to gain a price advantage in the competitive market. The intervenors in this proceeding are concerned that unless procedures for carrying out the Commission's affiliate transaction guidelines are in place before the transfer occurs, PBIS will be subsidized by monopoly ratepayers. According to the intervenors, failure to correctly price services provided by PBIS to Pacific and vice versa, failure to segregate the operations of Pacific and PBIS, and failure to enforce existing guidelines will confer on PBIS a subsidy that will guarantee it an ongoing competitive advantage over other enhanced services providers.

C. Reasonableness of Structural Separation

The transfer of ISG's personnel and assets to a separate corporation, though one affiliated with Pacific, could further protect ratepayers from the risks and rewards of competitive ventures undertaken by Pacific. No party, including DRA, objected to the proposal to place the enhanced service business unit in a separate Pacific subsidiary. All of the parties, except for Pacific, object to the terms and conditions of the transfer as proposed by Pacific. The intervenors urge the Commission to apply its existing affiliate transaction guidelines, not the rules proposed by Pacific, and to adopt DRA's method of valuing ISG for

the purpose of compensating utility ratepayers. Assuming the resolution of those issues in a manner that achieves our objective that ratepayers should be indifferent to the utility's venture into competitive services, the transfer of ISG personnel and assets to PBIS should be approved.

D. Valuation of Assets Transferred

Both Pacific and DRA agree that Pacific has been ordered not to transfer rights to its properties to unregulated affiliates at less than an independently appraised fair value. (See, affiliate transaction decision, Ordering Paragraph 34(c), 27 CPUC 2d at 62.) Pacific values the assets to be transferred at the adjusted net book values of the tangible assets used by ISG, such as switching equipment and computers. The value of ISG, then, is approximately $52 million, according to Pacific.

DRA disagrees with Pacific. According to DRA, the fair market value of the resources to be transferred should be assessed as if competitive bids for a going concern were being sought on the open market.

DRA describes three methods for ascertaining fair market value. The first is the cost to replace the property (fair market value of all assets less total liabilities), which is the value of the property to a knowledgeable investor. The second method is the market comparative approach, which derives a value based on the sale of comparable property. The third method is the income approach, which holds that the value of the business is equal to the future economic benefits derived from ownership of the business. Under the income approach, the future net cash flows available for distribution, discounted to present value by a market based rate of return, represent the fair market value of the business.

DRA believes the income approach is the proper means of establishing fair market value. Using Pacific's internal study of value, DRA proposes to value ISG at an amount several times the

value Pacific ascribes to ISG's physical assets. CBCHA supports DRA's recommendation.

As explained in greater detail below, we believe that regardless of whether ISG is transferred to PBIS, (1) the net book value of ISG shall be removed from Pacific's rate base used to calculate shareable earnings, and (2) the difference between ISG's going-concern value and its net book value shall be credited to ratepayers. Further discussion of this issue at this point is therefore unnecessary.

E. Fees for Specific Transactions Between Affiliates

1. Twenty-Five Percent Employee Transfer Fee

Pacific depicts the transfer of ISG's personnel and assets to PBIS as a transaction between nonregulated affiliates for which no transfer fee is required. Pacific has mischaracterized our below-the-line treatment of enhanced services as a decision to forego regulation of enhanced services. We have never ceded our regulatory authority over enhanced services. ISG is not a nonregulated affiliate of the utility.

Pacific seeks a waiver of the 25% employee transfer fee with respect to the initial mass transfer of 294 ISG employees to PBIS. Pacific agrees to pay the fee for subsequent transfers of Pacific employees to the affiliate. According to Pacific, ratepayers are not entitled to the 25% employee transfer fee because the Commission has determined that shareholders should bear the risks and benefits of the utility's venture into competitive services and the subject personnel operate services that were placed below the line by the NRF decision.

In support of its position, Pacific notes that the Commission did not assess the employee transfer fee when it established enhanced services as below-the-line; employees are simply transferring in their existing jobs from a below-the-line department of Pacific to a below-the-line corporation owned by Pacific; as of September 1991, 38% of ISG's employees had no

experience with Pacific prior to joining ISG; ISG's services have already borne these employees' training costs; and Pacific will not replace them, so ratepayers would not be harmed by the transfer and the fee is not needed.

DRA urges the Commission to enforce the 25% employee transfer fee. DRA discovered that prior to 1991, all PBIS employees were hired through Pacific. Of that number, 10% started in the ISG organization; the remaining were transferred from other regulated operations of Pacific. However, under DRA's analysis, a going concern valuation would take into consideration the market value of the entire ISG operation, including its employees. If the Commission were to value ISG as a going concern, DRA believes the 25% employee transfer fee should be applied only to subsequent employee transfers from Pacific to PBIS.

CCTA argues there is no authority compelling the Commission either to levy the fee against ISG or to forego the fee at the time it moved enhanced services below the line.

DRA's position on the issue of the employee transfer fee is reasonable and will be adopted. As explained in the affiliate transaction decision, "the focus (of the employee transfer fee) should be on approximating the market value of the benefits associated with such transfers, and received by the affiliates, including an analysis of the costs avoided by them as a result of obtaining employees from the regulated utility." (27 CPUC 2d 1, 137.) We find that the purpose of the employee transfer fee will be met through the valuation of ISG as a going concern. However, after ISG has been conveyed to PBIS, further transfers of Pacific employees to PBIS will be subject to the 25% employee transfer fee.

2. Thirteen Percent Referral Fee

Pacific would implement the 13% referral fee imposed by Ordering Paragraph 25 of D.87-12-067 by having PBIS pay Pacific 13% of the first month's revenue, including nonrecurring charges, resulting from a successful customer referral by Pacific to PBIS.

DRA states that 13% of the first month's revenues, including recurring and nonrecurring charges from new as well as subsequent additions to existing accounts, should be levied. CCTA suggests application of the 13% fee to the first year's revenue.

Pacific proposes that its sales force should be able to market PBIS's services. DRA agrees with this proposition provided there is a properly executed tracking mechanism in place. DRA and Pacific agree that for services provided by Pacific to PBIS, PBIS would pay Pacific higher of full cost plus 10% or market price in accordance with the rule governing the provision of nontariffed services by a utility to an affiliate.

CCTA objects to the joint marketing of affiliate services and monopoly utility services by Pacific's sales force. Pacific replies that Pacific currently sells enhanced services in a competitive market and no party has presented any evidence of harm to competition.

In the absence of any evidence of harm to competition, Pacific will be allowed to market services provided by its affiliate PBIS. We will prevent the affiliate from diverting ratepayer-funded marketing and customer services from the utility for the benefit of the affiliate by adopting DRA's recommendation. PBIS must compensate Pacific in an amount equal to 13% of PBIS's first month's nonrecurring and recurring revenues resulting from successful referrals for new as well as subsequent additions to existing accounts.

Pacific Telesis Group was ordered to establish a separate revenue account to book revenue received by an affiliate through a Pacific referral (affiliate transaction decision, Ordering Paragraph 34, subpar. (l), (m), and (q), 27 CPUC 2d 137.) Pacific states that the tracking plan is still under development. Approval of the proposed transfer is conditioned upon Pacific's submittal of a tracking plan that conforms with the requirements of the affiliate transaction decision to DRA and CACD for approval.

3. Cost Allocation

a. Continued Use of Transfer Pricing

Pacific proposes that the allocation of costs between PBIS and Pacific be determined under the transfer pricing rules instead of the currently used FCC Part 64 cost allocation rules, as modified by the Commission, since the assets, personnel, and operations formerly attributed to ISG will belong to an affiliate, rather than a below-the-line department. Transfer pricing, which is the higher of either cost plus 10% or market price, is used to determine costs for pricing nontariffed services provided to affiliates. Nontariffed services are defined as Operational Support Services (OSS) provided by Pacific to its affiliates through transfer pricing contracts.

We reviewed the use of Part 64 to segregate costs between regulated and nonregulated services when we discussed Category III, below-the-line services, in D.89-10-031. However, we distinguished the allocation of company overheads between utility and below-the-line services from the allocation of overheads to nontariffed services provided by a utility to an affiliate. While Part 64 requires that nontariffed services provided by a utility to an affiliate be priced at fully allocated cost, we rejected that principle. In D.89-11-031, we stated, "Commission policy is for the utility to price its nontariffed services provided to an affiliate at the higher of cost or market value. We will maintain current Commission policy in this regard."

DRA sought clarification that the "cost" referred to under the transfer pricing rule is the cost allocated under FCC Part 64, as modified by the Commission. As explained above in our response to the comments, we agree with DRA. This clarification will help ratepayers remain indifferent to any change between ISG's status as a department and PBIS's status as an affiliate of Pacific. Thus, there will be no shifting of costs from enhanced services to monopoly services. Accordingly, Pacific shall continue

to impute fully allocated cost as described in FCC Part 64 to enhanced services when pricing them at "full cost" under the transfer pricing rules.

Given this clarification, there is no reason to deviate from our transfer pricing rules. Pacific will charge PBIS the higher of either fully allocated cost plus 10% or market value for nontariffed services.

b. Need for Market Price Studies

Ordering Paragraph 34 (u) of D.86-12-026 directed Pacific to develop a study on the market prices of its nontariffed services to its affiliates.

Pacific and DRA have agreed that market studies should be performed only for services which result in over $100,000 of combined billings per year to affiliates, excepting billings to Pacific and Nevada Bell. If the study finds that market price is in fact higher than full cost plus 10%, Pacific would retroactively bill its affiliate the difference between the assessed rate and market price.

Pacific's application identifies 48 corporate services that ISG obtains from Pacific on a nontariffed basis. Pacific has commissioned market price studies for a number of services with aggregate annual billings to affiliates expected to exceed $100,000. Pacific's consultant designed and supervised the studies, which were performed by Pacific personnel. Thirteen market-pricing studies have been performed to date. In only four cases did market price exceed Pacific's cost plus 10%. Pacific prices employees loaned by Pacific, fleet management for the service motor pool, paralegal service, and real property management service to ISG at market price.

According to Pacific, in the majority of cases, the cost of a service plus the 10% surcharge consistently exceeds the market price of the service; further market pricing studies would be a waste of resources. Pacific plans to discontinue its market

price studies and would annually update the unit prices derived from existing studies by applying the Consumer Price Index (CPI) factor. In three to four years, the utility would undertake a new study of the services that have been studied, assuming that PBIS still uses the service at that time.

DRA questions the validity of the unit prices developed by Pacific because according to DRA, the studies are seriously flawed. DRA states that the studies did not simulate the services and were based on questionable assumptions. In addition, work papers were not made available to DRA for review as required by D.87-12-067 but were held back under an alleged "attorney-client privilege." DRA opposes Pacific's plan to discontinue any further market studies and to update the existing studies by the CPI factor.

DRA recommends that Pacific be limited to providing services which are "critical or essential to the operations of PBIS with respect to its parent company Pacific and are not readily available from a third-party provider." That is, Pacific should identify the critical or essential services needed by PBIS, develop a methodology consistent with D.87-12-067 for market pricing of those services, and formalize transfer pricing contracts for those services prior to offering them. According to DRA, this condition would reduce the administrative burden entailed by the pricing condition on both Pacific and Commission staff.

Pacific claims the "critical or essential" condition is not needed to protect ratepayers because the pricing rules motivate PBIS to limit the goods and services it receives from Pacific; since PBIS will want to control its costs, PBIS should gradually procure its goods and services from a third party at market price.

Here, Pacific seeks authority to transfer its ISG services to an affiliate. The Commission must review Pacific's compliance with the applicable affiliate transaction rules in

determining whether the transfer would be in the public interest. Pacific neither supported its study methodology nor responded to charges that it withheld information from DRA. Pacific's reliance on a CACD report to rebut DRA's assertions that its studies were flawed presumes that DRA has the burden of proof to show that Pacific's market studies were flawed. The utility is mistaken. Testimony by Pacific's witness reveals that ISG's existing usage of Pacific's resources has not been quantified through any cost allocation. Pacific did not rebut CCTA's claims that the safeguards ordered by previous Commission decisions are illusory since they are not in place.

We find that Pacific has not alleged a change in circumstances that renders unnecessary the requirement for market price studies. Pacific will not scale back any of the services it provides to ISG and expects to provide to PBIS. The utility did not identify which of the services were valued at more than $100,000 and would no longer be subject to study under its proposal to discontinue all market studies. It did not explain how its market study of 13 services demonstrates that cost plus 10% exceeds market price for the remaining transferred services.

Under these circumstances, we will affirm the requirement that Pacific conduct market pricing studies for goods or services it expects to provide to PBIS. However, studies are not necessary for goods or services which have an aggregate billing to all affiliates, except for Pacific and Nevada Bell, of less than $100,000 per year. These studies shall be completed no more than 180 days after the time Pacific reasonably discovers, or should have discovered, that the aggregate billing for the service in question has reached its $100,000 threshold. We also approve Pacific's proposal to use the CPI factor to annually update the market prices derived from the 13 studies it has already performed. A new market price study for each of those services will be due four years from the date of the original study if PBIS is still

being provided that service and the $100,000 threshold is met at that time.

In this application, Pacific proposes to transfer its enhanced services operation to a subsidiary. It is reasonable at this point to minimize the potential of cross-subsidization of the competitive subsidiary by the monopoly utility. We will limit Pacific's services to the critical or essential services needed by PBIS. "Critical or essential" is defined as a Pacific service that PBIS must have in order to operate in the manner authorized herein; it excludes services that PBIS could provide using its current or additional in-house personnel or could obtain through a third-party vendor without potentially disclosing proprietary PBIS information despite reasonable precautions. Pacific should then develop a methodology consistent with D.87-12-067 for market pricing of those services and formulate market prices accordingly.

The studies in their entirety will be made available to DRA as required by D.87-12-067; any claims of attorney-client privilege will be very carefully reviewed. CCTA recommended that the price studies should be available to counsel and consultants of interested parties. Given DRA's continuing oversight role, CCTA's recommendation is rejected.

4. <u>Pricing Pacific's Nontariffed Services to PBIS</u>

Pacific's witness testified that transfer pricing contracts are currently being developed in anticipation of the transfer of ISG to PBIS; however, she did not know whether Pacific has compiled information on ISG's current usage of Pacific's services or what the estimated costs of those services to ISG are.

Regardless of whether market price or fully allocated cost plus 10% is used, Pacific shall formalize transfer pricing contracts for those services prior to offering them to PBIS or to any other affiliate.

Pending completion of the market pricing studies, Pacific shall price the identified services at fully allocated cost plus

10%. We repeat that "full cost" shall be fully allocated cost, as that term is defined under FCC Part 64 and modified by the Commission.

a. PBIS Use of Proprietary Information

Pacific has drafted the "Telesis Guidelines" for the sharing of its proprietary information with affiliates.[8] This information has value that can be measured in monetary terms and would benefit an affiliate receiving the information. PBIS would pay for this information under the proposed Pacific/PBIS affiliate transaction guidelines unless it falls into one of the following exceptions: (1) The information is conveyed as part of a cooperative effort in response to litigation and regulatory proceedings, joint marketing activities, or for corporate governance. (2) The sharing without compensation is authorized in writing by a Pacific officer and endorsed by Pacific's general counsel and Pacific's vice president of corporate strategy.

DRA states that in order to ensure ratepayer indifference to Pacific's transfer of ISG assets to PBIS, the Telesis Guidelines must be amended for this case. The exceptions cited by Pacific should not be allowed; Pacific should be adequately compensated for this proprietary information under a transfer pricing contract.

Pacific argues that it would have created this type of information whether or not PBIS existed, allowing PBIS to have

8 These guidelines were previously subject to a DRA report on the compliance by Pacific and Telesis with the affiliate transaction guidelines adopted by D.87-12-067. Two years after the decision imposing guidelines and after reviewing DRA's report, CACD advised the Commission that the guidelines in the decision should be maintained and the policies, procedures, and reporting requirements developed by the Telesis/DRA/CACD monitoring committee should be continued. CACD recommended that no action was needed besides the informal monitoring of Telesis' ongoing reports.

such information at no cost would not harm ratepayers since no additional cost is incurred to create the information; ISG uses this information now; and PBIS's future use will not interfere with Pacific's use of the information, so ratepayers should be indifferent.

Pacific would surely object if the Commission required Pacific to provide that information, gratis, to PBIS's competitors. Among other things, this would weaken PBIS's competitive edge over other enhanced service providers. If the Commission adopted Pacific's position, it would rule in effect that PBIS is entitled to a strategic and marketing advantage over other providers free of charge, and that PBIS should have access to Pacific's ratepayers as a customer group in the same manner as the monopoly utility.

Pacific did not argue explicitly that it had such a right and we have never found that special advantage should be accorded to a Pacific affiliate. Our policy in favor of a level playing field and ratepayer indifference requires PBIS to compensate Pacific for proprietary information under the previously adopted transfer pricing methodology. Pacific's proposed exceptions are disapproved.

Except for "corporate governance" and "cooperative regulatory and litigation efforts" exceptions, proprietary information will be provided PBIS in connection with a good or service which is covered under a tariff or a transfer pricing arrangement. Since there is no tracking mechanism to document the transfer of proprietary information not associated with a particular good or service, Pacific should be required to track that provision of proprietary information to PBIS. The tracking shall include, at least, the type of information, derivation of price, charges paid by PBIS, and date of transaction. If proprietary information is created by Pacific specifically for PBIS, this will be done pursuant to a transfer pricing agreement.

b. PBIS Use of Intellectual Property

Pacific's guidelines regarding intellectual property transactions with PBIS require PBIS to compensate Pacific for the transfer of intellectual property, without exception. DRA recommends that before intellectual property is provided to PBIS, it should be "ensured that ratepayers will not be adversely impacted as a result of that disclosure." Pacific opposes this suggestion, stating that the very nature of intellectual property ensures that ratepayers still receive the benefit of the intellectual property and are not harmed if it is provided to another for the appropriate compensation.

Generally, Pacific is correct. However, we can envision a situation where DRA's proposal could provide ratepayers with an extra measure of protection. For example, ratepayers may be disadvantaged if the intellectual property is used by the competitive affiliate to provide a service which could have been provided at lower cost by the monopoly, but for corporate reasons, the company decided against the deployment of the service in a regulated setting. Ratepayers should never be adversely impacted by a transfer of goods or services from the utility to an affiliate. We will adopt DRA's condition.

c. Offer of Services to Third Parties

DRA recommends that Pacific provide third parties with access to its OSS on the same terms and conditions as provided to PBIS whenever Pacific's network has the capability to allow independent access. Pacific should charge for that use on a fully compensatory basis. Since DRA did not specify how ratepayer interests would be served and none of Pacific's potential competitors joined in this recommendation, Pacific will not be required to make its OSS available to third parties.

DRA recommended that the access to CPNI enjoyed by ISG under current FCC rules should be provided to PBIS. However, this recommendation was made before the FCC issued its latest order

on CPNI access. Consistent with the most recent FCC order on access to CPNI, PBIS and Pacific personnel involved in enhanced services marketing should obtain prior customer authorization before accessing the CPNI of customers with more than 20 lines. (In re: Computer III Remand Proceedings, CC Docket No. 90-623 report and order December 20, 1991, mimeo. p. 43.) Independent enhanced services providers must obtain advance authorization from the customer in order to obtain access to CPNI, so Pacific will not be required to provide third parties with CPNI information unless that authorization has been given.

5. Pricing PBIS Services to Pacific

The Telesis Guidelines allow nonregulated affiliates to sell services to Pacific at list price, and in the absence of a list price, full cost. PBIS services to Pacific should be provided at list price, according to Pacific. It claims that sales at list price fully protect the ratepayer and competitors because list price is what any supplier charges its customers on the open market.

Initially, Pacific itself will be PBIS's largest single source of revenue. At evidentiary hearing, Pacific's management reaffirmed its 1988 decision to buy voice mail services from ISG or its successor. Pacific sees no reason to bid out for this service to determine the market price for voice mail. Instead, Pacific is content to pay PBIS's "list price" for these services. No explanation was given as to how list price would be determined, although two factors would be considered. The first is the price that PBIS would charge a "comparable" customer. The only comparable customer cited had a potential demand of 11,000 voice mail boxes, compared to Pacific's' demand of 20,000 voice mail boxes. The second factor given was the potential for a discount from list price, based on Pacific's size.

CCTA notes that the Commission has never approved the list price concept. CBCHA fears the potential for price

discrimination between customers, since Pacific proposes to offer PBIS services on a nonregulated basis. In the case of voice mail service to Pacific, CBCHA claims to the extent that PBIS sets its list prices so as to generate a rate of return that exceeds the authorized level for Pacific's regulated services, the effect will be to inflate the costs of regulated monopoly services generally, for the purpose of creating excess below-the-line earnings for the company's shareholders.

DRA would expand the requirement for market price study to require Pacific to compare market prices before ordering a service from PBIS. In the alternative, DRA proposes a rule that would require Pacific to issue a request for proposal before purchasing a service from PBIS. DRA maintains that Pacific should not pay more for services formerly provided by ISG than if the PBIS affiliate had not been established. According to DRA, the transfer pricing principles, which would set Pacific's payment at the lower of either cost or market price, should apply to Pacific's procurement of voice mail from PBIS.

Pacific replies that even if there were economic harm due to PBIS's price, the shareholder and not the ratepayer would be harmed by the procurement decision because under NRF, Pacific cannot increase rates to cover costs incurred. Pacific claims that affiliate transaction monitoring requirements afford the Commission sufficient data from which to detect possible mismanagement by Pacific.

Pacific's proposed purchase of voice mail services from an affiliate presents the Commission with the opportunity to enforce the policy of ratepayer indifference that underlies our regulation of utility-affiliate transactions. That is, ratepayers should be no worse off whether the function is undertaken by the utility or contracted out to an affiliate. Since the transaction in question involves not only the transfer of assets but also the subsequent provision of service by the affiliate, we must condition

our approval of the transfer to promote ratepayer indifference to both phases of this anticipated transaction.

Pacific should pay PBIS the lower of either market value or fully allocated cost, as determined when the upgrade has been installed, for voice mail service from PBIS. This is simply the rule for any service provided by the affiliate to the utility established in D.86-01-026 to avoid cross-subsidization by ratepayers.

To summarize, we reject the concept of "list pricing" of PBIS services to Pacific because Pacific has not shown that its list pricing methodology would exclude the possibility of ratepayer subsidy to PBIS. DRA's competitive bidding requirement is rejected because we find the existing rule that an affiliate shall price its goods and services at the lesser of either market price or cost will adequately protect ratepayers and competitors.

F. Implementation and Enforcement Issues

1. Regulation of PBIS as a Telephone Utility

CCTA suggests that PBIS should be regulated as a telephone utility on the basis on PU Code § 234. It defines a telephone corporation to include every person or corporation "owning, controlling, operating, or managing any telephone line for compensation within this state." According to CCTA, ISG currently does so and PBIS will do the same.

We have never addressed the issue of whether or not a provider of enhanced services is a telephone utility. This issue, with its far-reaching implications, should be resolved in a generic proceeding that affords all interested parties an opportunity to be heard. We will reserve judgment on the question of whether PBIS should be regulated as a telephone utility for resolution at that time.

2. Tariffing PBIS Services

DRA and CCTA recommend PBIS be required to file tariffs for each enhanced service. Pacific opposes this suggestion, noting

that the Commission decisions authorizing it to introduce enhanced services did not require it to file tariffs for each new service.

The Commission's earlier decisions authorizing Pacific to offer enhanced services did not require Pacific to file tariffs for those services. However, the Commission issued those decisions when there was an outstanding FCC order prohibiting states from tariffing enhanced services. That FCC order was later overturned by the U.S. Court of Appeals for the Ninth Circuit. (California v. FCC, 905 F. 2d 1217 (1990).) Thereafter, the Commission required the tariffing of Pacific's proposed fax store and forward service. (See D.90-07-052 and D.91-04-072.) Similarly, the Commission has required GTE California to tariff its voice messaging services. (See D.91-04-024.) We note that the enhanced services presently proposed for transfer to PBIS include Pacific's voice mail and fax store and forward service as well as several similar services: electronic messaging and voice store and forward.

As noted above, the complex issue of whether a provider of enhanced services, such as PBIS, is a telephone corporation as defined by PU Code § 216 should be resolved in a generic proceeding. Whether PBIS must tariff its services is closely related to that issue, and therefore should also ultimately be resolved in that generic proceeding. In such a proceeding we could also consider the policy arguments for and against requiring tariffing of enhanced services offered by a subsidiary of a telephone corporation. However, if we are to authorize Pacific to transfer enhanced service operations to PBIS at this time, we must reach some interim resolution of the tariffing issue.

The parties to this proceeding have focused mostly on the accounting implications of transferring enhanced services operations to a separate subsidiary. They have not strongly debated whether it would still be desirable to authorize the transfer *if* one result of that authorization would be to exempt

PBIS from having to tariff services that Pacific would be required to tariff if it continued to offer them.

We do not wish to foreclose our consideration of the tariffing issue by authorizing Pacific's proposed transfer. Therefore, we will authorize the transfer subject, at least for the time being, to PBIS's compliance with the same tariffing requirements that we would have imposed on Pacific.[9] Thus, consistent with D.90-07-052, D.91-04-072, and D.91-04-024, we will require PBIS to file tariffs for the enhanced services it presently plans to offer and, absent any further Commission order to the contrary, for any additional enhanced services it offers. Furthermore, as a condition of our approval of the transfer of Pacific's ISG department to PBIS we will require the consent of Pacific and PBIS to tariffing of PBIS's services so long as the Commission shall so order.

In imposing these requirements, we do not intend in any way to prejudge our ultimate decision on the tariffing issue. We merely wish to leave our options open. Indeed, we are currently seeking legislation that would authorize us to waive the tariffing requirements of PU Code § 489(a), in full or in part, for enhanced services. However, until such time as we can look at the tariffing issue more thoroughly in a generic proceeding, we are simply requiring PBIS, because it is the subsidiary of a telephone utility and will receive substantial assets from Pacific, to comply with the same tariffing requirements we would now impose on Pacific.[10]

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9 These tariffing requirements are set forth in General Order (GO) 96-A, as modified by Ordering Paragraph 4 of D.89-10-031. If PBIS wants an even more streamlined process for rate changes, it should seek such approval. (See D.90-07-052, 33 PUC2d 33, 39.)

10 Indeed, Pacific has recently filed an advice letter with proposed tariff sheets (not yet effective) for its enhanced service offerings.

3. Accounting and Reporting Requirements

DRA reviews several prior Commission decisions which established accounting and reporting requirements for utility affiliates. It asks the Commission to explicity require Pacific to adhere to those requirements in this case.

Pacific states that it will separate services applicable to PBIS between below-the-line services and those subject to the sharing mechanism in a manner that corresponds directly to FCC Part 32 accounts (47 CFR § 32.1 et seq.). We assume that Pacific will also separately maintain accounts receivable and accounts payable for each Telesis affiliate with which PBIS will do business.

Pacific has cited the affiliate transaction monitoring process as proof that its internal affiliate transaction guidelines effectively carry out the Commission's affiliate transaction orders. We assume that Pacific will continue to provide financial statements to the Commission staff (DRA and CACD) in the format and with content agreed to by DRA and Pacific in the monitoring workshops. This will require PBIS to file total operations financial statements and service-specific financial statements for reporting the development costs of future services as ordered in D.88-11-027, Ordering Paragraph 2 (29 CPUC 2d at 484) and finally adopted in D.89-10-031, Ordering Paragraph 17 (33 CPUC 2d 195, 235).

DRA recommends that Pacific be directed to inform the Commission of any new services that PBIS will provide or new lines of business that PBIS plans to enter into prior to their implementation. DRA also seeks updated organizational charts from Pacific as changes occur.[11] Both of these informational requirements will enable the Commission staff and Pacific to

11 Such charts were required in D.87-12-067, Ordering Paragraph 34(a) and D.89-10-031, Ordering Paragraph 17.

coordinate their assessment of what, if any, accommodations must be made to the affiliate transaction guidelines. These recommendations will be adopted.

4. Ratemaking Adjustments

We divide our ratemaking discussion into two parts. First, we shall discuss ISG's transfer to below the line and second, the transfer of ISG to PBIS. In doing so, we shall discuss and reaffirm principles that this Commission laid down in the NRF decision and examine Pacific's compliance with those principles.

At hearing there seemed to be consensus that reward should follow risk. However, the parties disagreed in the application of this principle. The parties' disagreement stemmed from a dispute over whether (1) the NRF decision directed Pacific to include ISG's expenses in its start up revenue requirement, and (2) whether "cost of service" associated with ISG was included in the revenue requirement.

a. Transfer of ISG Below the Line

After careful review of the record and the NRF decision we conclude that Pacific failed to follow principles this Commission enunciated in the NRF decision.[12] Accordingly, we

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12 We are convinced by the evidence presented at hearing that Pacific included ISG's cost in its revenue requirements and to date has never removed those costs. In a response to a DRA report, dated December 20, 1990, Pacific stated that its "start up revenue adjustment compliance filing to the Commission...was based on...revenues and expenses...including expenses for Voice Mail, California Call Management, and PB Connection." (DRA prepared testimony p. 7-5.) At hearing Pacific's own witnesses testified that "it didn't do anything to its books" to take the enhanced services below the line. (Testimony of Dennis Evans, volume 3, p. 276, line 14.) Moreover, we are alarmed by the fact that Pacific admitted at hearing that "some" expenses and assets were above the line but was unable or chose not to provide any concrete financial numbers.

direct Pacific to correct those deficiencies regardless of whether or not Pacific transfers ISG to PBIS.

i. Cost of Service

In general, "cost of service" means the utility's operating expenses incurred in providing a service, depreciation, income taxes and a reasonable return on investment. The NRF decision (D.89-10-031), addressed the issue of allocating the cost of ISG's services. The Commission ordered that these services be "given below the line treatment"[13] because they posed a great investment risk.[14] Accordingly, the Commission "excluded [these services] from the basic sharing mechanism."[15] By definition "below the line" treatment means that cost of service is not included in the revenue requirement.[16]

The intent of the Commission in placing these services below the line was twofold. First, shareholders were to

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13 Ordering Paragraph 8, adopting Conclusion of Law 36.

14 NRF decision, Finding of Fact 74.

15 NRF decision, Ordering Paragraph 8, adopting Conclusion of Law 35.

16 Pacific contends that it properly placed ISG's expenses above the line pursuant to NRF. In Ordering Paragraph 14(d) of NRF, we ordered Pacific to provide the Commission with intrastate <u>ratemaking</u> expenses for the purpose of calculating Pacific's start up revenue requirement. We note that Ordering Paragraph 14(d) of NRF used the term "ratemaking." We believe this term should exclude below the line expenses which are not appropriate to include in a <u>ratemaking</u> revenue requirement. Even if Pacific found the language of 14(d) to be somewhat ambiguous, it would not override the clear language of Ordering Paragraph 8, incorporating Conclusion of Law 36, that these costs should be below the line. To conclude that NRF allowed these costs to remain above the line would torture and contradict the letter and spirit of the NRF decision.

bear 100% of the risk and receive 100% of any profits. Second, placement below the line was designed to relieve ratepayers of the burden of paying the expenses associated with these services. Accordingly, Pacific should have excluded the "cost of service" associated with these services in calculating its start up revenue requirement.

To rectify its failure to do so, the "cost of service" associated with all services placed below the line should be excluded from Pacific's rates. Thus, Pacific should reduce its rates by an amount equal to the cost of service associated with the services which are the subject of this decision. We note, however, that by the Telesis Audit Decision being issued today, we require Pacific to make an adjustment for that purpose.[17] We therefore refrain from ordering Pacific, in this decision, to make any further adjustment to its rates to remove the "cost of service" associated with the services which are the subject of this decision.

ii. Assets in Rate Base

In accordance with the NRF decision, Pacific should not have included ISG's assets in its rate base. As previously articulated, the NRF decision dictated that ISG's services be excluded from the sharing mechanism. If ISG's assets are included in rate base, then their inclusion will have the effect of increasing the threshold for triggering the sharable earnings mechanism. Accordingly, to the extent that Pacific has included ISG's assets in its rate base, it should remove those assets from its rate base, using net book value.

17 The Audit Decision also requires Pacific to refund past overcollections.

iii. Difference Between Going Concern Valuation and Net Book Value

The above treatment of ISG's services is consistent with our decision in NRF. However, we must address the fact that ISG is a valuable business which has had some, if not all, of its expenses paid by ratepayers from 1984 to the present, contrary to our stated intention in the NRF decision.

Ratepayers therefore should be compensated when ISG's costs are moved from above the line to below the line, regardless of whether ISG's assets are transferred to PBIS. Ratepayers should receive the difference between going concern value and net book value.

Our decision here resolves challenging issues which we do not want to face again in the future. The matter is one of first impression which Pacific forced upon the Commission by its failure to place costs associated with enhanced services below the line as we ordered it to do in the NRF decision. The NRF decision was not directly helpful in reaching today's decision, because it did not anticipate or address the situation we face today: Pacific's noncompliance with the NRF decision's directives concerning which costs it should include in its start-up revenue requirement. Consequently, the decision we reach here today is limited, and not intended to serve as a broad precedent. The broader issues relating to a transfer of assets below the line are important. They are addressed in part by the settlement we approve in the Telesis Audit Decision today and we will likely address them further in the NRF review presently underway. These broader issues are simply not addressed by this decision.

Because NRF does not provide any specific guidance as to how to resolve the questions raised by Pacific's initial noncompliance, today's decision is based in large part on equity. Nevertheless, for background purposes, it is important to understand our intended result under NRF. Under the NRF decision,

shareholders were to bear the risks of enterprises such as these, in return for any profits that might result. The NRF decision declared that profits from enhanced services funded by shareholders should not be shared with ratepayers because of the risks assumed by the shareholders. With respect to category III services, we indicated that reward should follow risk. We interpret the concept of "bearing risk" to include the funding of expenses. We believe that one of the risks that shareholders should have borne is the cost of funding the development and operation of ISG, regardless of whether it proved to be a money-making enterprise.

However, here, contrary to the spirit of NRF and our express statement that these services should be placed below the line, ratepayers were burdened with the responsibility of funding the development and operation of ISG through rates. (DRA presented convincing evidence that ratepayers were charged approximately $19 million annually since 1990 for costs associated with ISG.) Shareholders did not bear the financial risks of funding ISG's expenses to the extent they were expected to. For these reasons shareholders should not receive the increase in the value of ISG that they would otherwise be entitled to. Therefore, we are directing Pacific to credit ratepayers with the increase in the value of ISG (i.e., the difference between its going-concern value and its net book value).[18] The credit should be reflected

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18 There is a risk that there is some double-recovery in giving ratepayers both (i) the refund of past overpayments for ISG costs that we order in the Audit Decision today, and (ii) the increase in the value of ISG that we order here. The degree to which there is such double-counting, if any, is difficult to discern because of the undeveloped record on this issue. Pacific is keeper of the books and therefore in the best position to determine whether double-counting has occurred. If it believes there is some double-counting, we urge it to raise the issue in a petition to modify this decision as soon as possible.

as a one time adjustment to Pacific's rates.[19] The going-concern value shall be calculated as of 60 days after the date of this order. This is to coordinate with the date as of which Pacific will cease receiving the cost of service associated with ISG pursuant to the Telesis Audit Decision we issue today.

iv. Valuation as a Going Concern

Pacific argues that valuation of ISG as a going concern negates the Commission's allocation of profits as an incentive to offer competitive services. Pacific quotes this passage from the NRF decision: "(W)e conclude that it would be reasonable to provide the incentive of allowing local exchange carriers to keep all profits from these services." (33 CPUC 2d 146.)

Pacific's argument would be persuasive if it had initiated enhanced services operations below-the-line. The facts are otherwise, however. Enhanced services were developed within the utility as early as 1984. There is no evidence that any funds besides ratepayer-provided funds were used to develop those services. Pacific argues that its test year 1986 rates were based on a review of actual costs incurred during 1983 and 1984 and DRA's identified product development costs were incurred after test year 1986 rates had been set. Thus, according to Pacific, the cost of developing enhanced services was not borne by ratepayers. However, this argument is no basis for finding that shareholder funds, as opposed to other sources, (such as a redirection of ratepayer funds originally proposed for another purpose), were used to develop enhanced services. Indeed, Pacific has never asserted in this

19 Pacific shall file an advice letter to reduce its rates by means of a surcredit spread over one year. The surcredit shall be applied to intrastate access services, and intraLATA toll and (including toll private line) exchange services.

proceeding that product development was funded from retained shareholder earnings.

If Pacific's shareholders were to keep the difference between the book value of ISG's assets and its valuation as a going concern, none of the intended incentives would materialize. ISG is an existing service. It is not one whose feasibility is being studied for potential deployment at shareholder expense. The difference in book and going concern value was gained by risking ratepayer funds, not shareholder funds. If ratepayer compensation were limited to the net book value of ISG's assets, the only resulting incentive would be for Pacific to develop a potentially competitive service within the utility and then to transfer the service to an unregulated affiliate. This would impose the risk of competition on ratepayers but confer windfall profits on shareholders.

To value ISG on the basis of its office leases, computers and related equipment is inconsistent with the facts. ISG is a successfully operating department within Pacific that competes against other enhanced services vendors in the open market. ISG currently provides voice mail service to Pacific, and Pacific has offered enhanced services to the public since as early as 1988. Moreover, Pacific's witness testified that Pacific intends to continue to obtain voice mail services from ISG or its successor, and that regardless of the outcome of this proceeding, ISG's equipment will be replaced with more versatile technology that can meet Pacific's expected demand of approximately 22,000 voice mail stations.

CCTA highlighted the following additional evidence in support of valuation as a going concern: PBIS will be sharing Pacific's marketing information, strategic plans, forecasts of financial information and operational plans, customer proprietary network information, and internal Pacific services to the same degree that ISG has enjoyed access to that information.

We find that under these circumstances, valuation at fair market value means that ISG should be valued as a going concern, and that replacement of the physical assets of the enterprise is insufficient and inappropriate. The market competitive approach for valuing ISG seems implausible, as we are not aware of similar sales of similar companies. In short, the income approach is the one available and appropriate method for valuing ISG.

v. Reliance on Pacific's Internal Business Case

DRA proposes a valuation of ISG based on the future profits forecasted by Pacific in its own internal valuation. Pacific objects to this use of its study since it did not conduct the study for the purpose of a going concern valuation and it did not address the appropriate cost of capital and capital structure, working capital requirements, prior investment, or the time of tax losses or benefits. Pacific used its own corporate characteristics as inputs. According to Pacific, if other variables were used, the value derived by its internal study could be reduced by 50%. Pacific recommends that if valuation of a going concern is required, it should be done by an independent appraisal.

DRA responds that a business that realistically could purchase ISG would have financial characteristics similar to those of Pacific. Such an entity might be another RBOC or a large integrated corporation. In that case, the working capital, financing, value of tax losses, and other assumptions would be fairly constant as between Pacific and a likely purchaser. Thus, DRA believes that Pacific's internal valuation is a reliable estimate of a purchaser's valuation of ISG as a going concern. Moreover, DRA directs our attention to the recent decision of U.S. District Court authorizing the RBOCs to enter information services in general. This, posits DRA, could increase the value of ISG to Pacific relative to its value to a third-party purchaser; in that

case, it is fair to use Pacific's own valuation, which is specific to its own internal operations.

We conclude that ISG should not be valued on the basis of Pacific's internal business case. There was no evidence of the means of preparation or the intended use of the business case that would indicate the appropriateness of its use to forecast ISG's future profits. Moreover, both Pacific and DRA state that the fair market value of ISG should be determined by independent appraisal. This recommendation is consistent with our affiliate transaction guidelines. ISG will be valued as a going concern on the basis of the recommendation of an impartial qualified appraiser. Pacific will provide the appraiser with all relevant data necessary to conduct the appraisal, including Pacific's internal business case and the associated work papers for comparison, and will make available to DRA all work papers relating to the appraisal.

b. Transfer of ISG to PBIS

Pacific may transfer ISG to PBIS at any time subject to compliance with the conditions set forth herein. Subsequent to the actions mandated above the transfer should have no effect on Pacific's rate design since ISG will properly be below the line.

V. Conclusion

We have affirmed the application of the Commission's existing affiliate transaction rules to this case and specified that valuation under these circumstances shall be of ISG as a going concern. Subject to Pacific's compliance with these conditions, the transfer of the personnel and transfer of Pacific's ISG department to PBIS, a wholly owned subsidiary of Pacific, would serve the interests of Pacific's ratepayers and shareholders. Accordingly, the application of Pacific is approved, subject to the conditions provided herein.

Findings of Fact

1. On December 27, 1990, Pacific filed the instant application to transfer the personnel and assets of its ISG.

2. ISG is a department within Pacific that provides enhanced services. These services currently consist of voice mail, electronic messaging, voice store and forward services, and fax store and forward services.

3. Pacific would transfer the personnel and assets of ISG to PBIS, a California corporation created on November 1, 1990, in exchange for all PBIS stock.

4. The four enhanced services provided by ISG were designated as "Category III" services by D.89-10-031; the NRF decision ordered their costs and revenues to be recorded below-the-line.

5. The NRF decision ordered that revenues from ISG services not be subject to the NRF shareholder/ratepayer sharing mechanism adopted by D.89-10-031.

6. ISG manages voice mail services for Pacific. The utility is planning to retire the existing voice mail system and have ISG, or its successor PBIS, provide a more modern and versatile voice mail system.

7. The system to be phased out is in Pacific's regulated accounts.

8. Under the proposal, Pacific would pay PBIS the "list price" for voice mail and other enhanced services, subject to an unspecified discount based on factors such as the volume of its demand or an extended term of contract.

9. Under the proposed transfer, PBIS would be wholly owned by Pacific. PBIS's expenses, losses, and future gains would accrue directly to Pacific's shareholders. Its net revenues would be paid to Pacific as dividends. These dividends would accrue below the line so that PBIS earnings will flow directly to Pacific's shareholders.

10. The affiliate transaction rules that govern the instant proposal were adopted in three decisions.

11. D.86-01-026 established rules for pricing services billed to Pacific's affiliates (transfer pricing rules) and for payments made by the utility to its affiliates (affiliate payments).

12. D.87-12-067 requires an affiliate to pay Pacific a 25% premium for each utility employee it hires and a 13% premium payable when a sale results from a customer referral by the utility.

13. D.87-12-067 requires that ratepayers be made indifferent to any utility-affiliate transactions through compensation for any flow of resources or benefits from the utility to an affiliate.

14. In D.89-10-031, the NRF decision, the Commission adopted a cost allocation methodology to segregate the costs of Category III services so that they could be excluded from the monopoly utility's net revenues, i.e. be placed below the line. The adopted methodology uses fully allocated embedded costs based on the FCC's Part 64 rules, except in one material respect.

15. Part 64 requires that nontariffed services be priced at fully allocated cost, while D.89-10-031 specifies that the CPUC's policy requires the utility to price its nontariffed services to an affiliate at the higher of cost or market value.

16. In an interim decision on development costs, the Commission rejected a settlement between Pacific and DRA because it failed to refund to ratepayers past subsidies of competitive services (D.91-11-023, mimeo. p. 3).

17. In D.91-11-023, this Commission found that ratepayers have funded the development of competitive services in the past and that the ISG cost of service was not placed below the line when Pacific's NRF start-up revenue requirement was adopted.

18. There are a number of ratemaking issues that must be addressed to maintain the principle of ratepayer indifference and to provide compensation for the flow of benefits. These issues include the prices that PBIS and Pacific will pay each other for assets and services, and compensation to ratepayers for the cost of developing a Category III service.

19. If PBIS charged Pacific an unfairly high rate, ratepayers would be adversely affected because Pacific would experience greater costs, and fewer net revenues would be available to reach the sharings threshold established in D.89-10-031 as part of the new regulatory framework.

20. If PBIS charged Pacific an unfairly high rate, shareholders would be indifferent to the decrease in sharable earnings because the profit from PBIS operations would accrue directly to them.

21. If PBIS did not compensate Pacific adequately to allow Pacific to recover its costs, the lower cost of service may enable PBIS to earn shareholder profits on its operations while preventing Pacific from realizing earnings that would otherwise be shared with ratepayers.

22. PBIS's competitors fear that revenues from the monopoly utility will enable PBIS to gain a price advantage in the competitive market.

23. Procedures for carrying out the Commission's affiliate transaction guidelines must be in place before the transfer occurs, to avoid any potential that PBIS will be subsidized by monopoly ratepayers.

24. The transfer of ISG's personnel and assets to a separate corporation, though affiliated with Pacific, could further protect ratepayers from the risks and rewards of competitive ventures by Pacific.

25. No party, including DRA, objected to the proposal to place the enhanced service business unit in a separate Pacific subsidiary.

26. D.87-12-067 requires Pacific to receive the independently appraised fair value of any property that it transfers to its affiliates.

27. Pacific values the assets to be transferred at the adjusted net book values of the tangible assets used by the ISG, such as operating leases (buildings, furniture, and office

equipment), switching equipment, and computers. The value of ISG is approximately $52 million, according to Pacific.

28. DRA claims that the fair market value of the resources to be transferred should be assessed as if competitive bids for a going concern were being sought on the open market.

29. Our policy assigning the entitlement to gain is not premised on any ownership interest.

30. There is no evidence that any funds besides ratepayer-provided funds were used to develop ISG.

31. In this case, ratepayers have funded the development of enhanced services.

32. The income approach is the proper means of establishing the fair market value of ISG. ISG is a going concern; ratepayers have paid its development costs, ratepayers have borne its operational expense for roughly six years, and ISG is expected to generate substantial income, according to Pacific's internal business study.

33. If Pacific's shareholders were to keep the difference between the book value of ISG's assets and its valuation as a going concern, shareholders would receive a windfall that was gained by risking ratepayer funds, not shareholder funds.

34. The only resulting incentive would be for Pacific to undertake development of a potentially competitive service within the utility and then to transfer the service to an affiliate.

35. The results of Pacific's internal valuation of ISG's expected revenues should not be used as the income approach for valuation because it was not prepared by an independent appraiser.

36. The fair market value of ISG as a going concern should be ascertained, using the income approach, by an independent appraiser having full access to Pacific's relevant books of account.

37. Pacific seeks a waiver of the 25% employee transfer fee with respect to the initial mass transfer of ISG employees to PBIS; however, it would pay the fee for subsequent transfers of Pacific employees to the affiliate.

38. The required going concern valuation will take into consideration the market value of the entire ISG operation, including its employees; therefore, the 25% employee transfer fee shall be applied only to subsequent employee transfers from Pacific to PBIS.

39. Pacific should implement the 13% referral fee imposed by Ordering Paragraph 25 of D.87-12-067 by having PBIS pay 13% of the first month's revenue, including nonrecurring charges from new as well as subsequent additions to existing accounts, that results from a successful referral by Pacific to PBIS.

40. Pacific's sales force may market PBIS's services so long as there is a properly executed tracking mechanism in place.

41. Approval of the proposed transfer is conditioned both upon Pacific's submission of a plan to track revenues received by an affiliate as the result of a Pacific's referral conforming with the requirements of the affiliate transaction decision, and upon CACD's approval of the plan.

42. Transfer pricing, which is the higher of either full cost plus 10% or market price, is used to determine costs for pricing nontariffed services provided to affiliates.

43. The allocation of costs between PBIS and Pacific will be determined under the transfer pricing rules instead of the currently used FCC Part 64 cost allocation rules since the assets, personnel, and operations formerly attributed to ISG will belong to an affiliate, rather than a department that was placed below the line.

44. Pacific shall continue to impute fully allocated cost as described in FCC Part 64, as modified by the Commission, to enhanced services when pricing them at "full cost" under the transfer pricing rules.

45. For services provided by Pacific to PBIS, PBIS will pay Pacific the higher of fully allocated cost plus 10% or market price in accordance with the rule governing the provision of nontariffed services by a utility to an affiliate.

46. Ordering Paragraph 34 (u) of D.86-12-026 directed Pacific to develop a study on the market prices of its nontariffed services to its affiliates. Nontariffed services are defined as operational support services provided by Pacific to its affiliates through transfer pricing contracts.

47. Pacific has not alleged a change in circumstances that renders unnecessary the requirement for market price studies. Its request to discontinue additional market price studies for goods or services it expects to provide to PBIS is denied.

48. Market studies need be performed only for services which result in over $100,000 combined billings per year to affiliates, excepting billings to Pacific and Nevada Bell.

49. If the market study finds that market price is in fact higher than full cost plus 10%, Pacific shall retroactively bill its affiliate the difference between the assessed rate and market price.

50. Pacific's proposal to use CPI to annually update the market prices derived from the 13 studies it has already performed is reasonable, so long as new market price studies for each of those services are produced four years from the date of the original study if PBIS is still being provided that service at that time and the $100,000 threshold is met.

51. To minimize the potential of cross-subsidization of the competitive subsidiary by the monopoly utility, Pacific must identify the critical or essential services needed by PBIS.

52. "Critical or essential" is defined as a Pacific service that PBIS must have in order to operate in the manner authorized herein; it excludes services that PBIS could provide using its current or additional in-house personnel or could obtain through a third-party vendor without potentially disclosing proprietary PBIS information despite reasonable precautions.

53. Pacific must develop a methodology consistent with D.87-12-067 for market pricing of critical or essential services and formulate market prices accordingly.

54. Regardless of whether market price or fully allocated cost plus 10% is used, competitive safeguards will be operational only if Pacific formalizes transfer pricing contracts for critical or essential services prior to offering them to PBIS or to any other affiliate.

55. Pending completion of the market pricing studies, the proper price to be charged PBIS is fully allocated cost plus 10%.

56. PBIS proposes to pay for proprietary information supplied by Pacific under the proposed Pacific/PBIS affiliate transaction guidelines unless it falls into one of the following exceptions: (a) the information is conveyed as part of a cooperative effort in response to litigation and regulatory proceedings, joint marketing activities, or for corporate governance, and (b) the sharing without compensation is authorized in writing by a Pacific officer and endorsed by Pacific's general counsel and Pacific's vice president of corporate strategy.

57. Consistent application of our policy in favor of a level playing field and ratepayer indifference requires PBIS to compensate Pacific for all proprietary information under the previously adopted transfer pricing methodology. As a result, Pacific's proposed exceptions are disapproved.

58. Pacific should be required to track the provision to PBIS of proprietary information not associated with a particular good or service. The tracking shall include, at least, the type of information, derivation of price, charges paid by PBIS, and date of transaction.

59. Because it is possible for Pacific to transfer intellectual property to PBIS and enable its shareholders to profit from that property to the detriment of ratepayers, Pacific must ensure that ratepayers will not be adversely impacted as a result of that disclosure.

60. Pacific will not be required to make its OSS available to third parties.

61. PBIS and Pacific personnel involved in enhanced services marketing should obtain prior customer authorization before

accessing the CPNI of customers with more than 20 lines. Independent enhanced services providers must obtain advance authorization from the customer in order to obtain access to CPNI, so Pacific will not be required to provide third parties with CPNI information unless so authorized by the customer.

62. The affiliate transaction guidelines promulgated by Pacific allow nonregulated affiliates to sell services to Pacific at list price, and in the absence of a list price, full cost.

63. The Commission has never approved the list price concept.

64. Pacific has not shown that its list pricing methodology would exclude the possibility of ratepayer subsidy to PBIS.

65. Pacific must pay PBIS the lower of either market value or fully allocated cost, as determined when the upgrade has been installed, for voice mail service from PBIS.

66. The existing rule that an affiliate shall price its goods and services at the lesser of either market price or cost will adequately protect ratepayers and competitors.

67. The issue of whether or not a provider of enhanced services is a telephone utility is best resolved in a generic proceeding that affords all interested parties an opportunity to be heard.

68. Pacific may transfer ISG to PBIS if Pacific and PBIS agree that PBIS will file tariffs for its services so long as required by Commission order.

69. Pacific will separate services applicable to PBIS between below-the-line services and those subject to the sharing mechanism in a manner that corresponds directly to FCC Part 32 accounts.

70. Pacific will separately maintain accounts receivable and accounts payable for each Telesis affiliate with which PBIS will do business.

71. Pacific will continue to provide financial statements to the Commission staff (DRA and CACD) consistent in format and content to that which was agreed to by DRA and Pacific in the monitoring workshops. This will require PBIS to file total operations financial statements and service-specific financial

statements for reporting the development costs of future services as ordered in D.88-11-027, Ordering Paragraph 2 (29 CPUC 2d at 484) and finally adopted in D.89-10-031, Ordering Paragraph 17 (33 CPUC 2d 195, 235).

72. Pacific will inform the Commission of any new services that PBIS will provide or new lines of business that PBIS plans to enter into prior to their implementation and provide the DRA and CACD with updated organizational charts as changes occur.

73. It is necessary for Pacific to adjust its current rate base to exclude plant, and other items associated with ISG so that ratepayers will not bear a revenue requirement for ISG in the future.

74. At hearing, the parties disagreed over whether D.89-10-031 directed Pacific to include ISG's expenses in its start-up revenue requirement and whether "cost of service" associated with ISG was included in the revenue requirement.

75. "Cost of service" generally means the utility's operating expenses incurred in providing a service, depreciation, income taxes, and a reasonable return on investment.

76. D.89-10-031 (the NRF decision) directed that ISG's services be below the line. This was designed, among other things, to relieve ratepayers of the burden of paying the expenses associated with these services.

77. D.89-10-031 found that ISG's services posed a great investment risk.

78. D.89-10-031 excluded ISG's services from the basic sharing mechanism. Shareholders were expected to bear 100% of the risk and therefore receive 100% of any profits. In other words, reward follows risk.

79. Pacific included ISG's costs in its revenue requirement and to date has never removed those costs.

80. Pacific should have excluded the "cost of service" associated with ISG's services in calculating its start-up revenue requirement, but did not do so. Shareholders did not bear the

financial risks of funding expenses to the extent they were expected to.

81. Pacific should not have included ISG's assets in its rate base.

82. Improper inclusion of ISG's assets in rate base will have the effect of increasing the threshold for triggering sharable earnings mechanism.

Conclusions of Law

1. The proposed transfer of personnel and assets of the ISG within Pacific to PBIS, a wholly owned subsidiary of Pacific, would be in the public interest only if subject to the Commission's affiliate transaction rules.

2. The preservation of ratepayer indifference to a proposed utility-affiliate relationship requires the review and application of the Commission's affiliate transaction rules under the specific circumstances of each proposed utility-affiliate transaction.

3. Ratepayer indifference to the proposed transfer can be assured only if Pacific conforms to the Commission's affiliate transaction rules set forth in D.86-01-026, D.87-12-067, and the establishment of Category III treatment for competitive services in D.89-10-031.

4. In adopting the affiliate pricing rules, the Commission simply intended to price at the higher of either market cost or the cost due under the previously adopted transfer pricing rule. Since the earlier rule required pricing at fully allocated cost, payments under the affiliate transaction guidelines shall be the higher of market price or fully allocated cost. This clarification of the term "full cost" as used in the transfer pricing rules to mean "fully allocated cost as described in FCC Part 64," as modified by the Commision, helps ensure that ratepayers are indifferent to the allocation of costs between a department within the utility performing Category III services and a utility-owned subsidiary.

5. Though Pacific failed to move ISG's services below the line pursuant to D.89-10-031 (the NRF decision), the Commision should not make an adjustment to remove the associated cost of

service from Pacific's rates in this decision, because an adjustment for that purpose is ordered in the Telesis Audit Decision issued today.

6. To the extent Pacific has included ISG's assets in rate base, it should remove those assets from rate base, using net book value.

7. Because NRF does not provide any specific guidance as to how to resolve the questions raised by Pacific's initial noncompliance, today's decision is based in large part on equity.

8. In light of Pacific's noncompliance, shareholders should not receive the increase in the value of ISG that they would otherwise be entitled to.

9. Ratepayers should be compensated when ISG's costs are moved from above the line to below the line, whether or not ISG's assets are transferred to PBIS.

10. Pacific should credit ratepayers with the increase in the value of ISG, defined as the difference between its going-concern value and its net book value.

11. The credit described in the preceding conclusion should be reflected as a one-time adjustment to Pacific's rates.

12. The going-concern value should be calculated as of 60 days after the date of this order, so as to coordinate with today's decision approving the settlement in the Telesis Audit case.

O R D E R

IT IS ORDERED that:

1. Pacific Bell (Pacific) shall remove the assets (net of depreciation) of Information Services Group (ISG) from its rate base for the purpose of the sharable earnings calculation, regardless of whether the assets of ISG are ultimately transferred to Pacific Bell Information Services (PBIS). Pacific shall file a report within 60 days of this order showing compliance with this ordering paragraph.

2. Regardless of whether the assets of ISG are ultimately transferred to PBIS, Pacific shall credit ratepayers with the difference between the going-concern value of ISG and the net book value of ISG. ISG shall be valued as a going concern based on the income approach as described in the Division of Ratepayer Advocates's (DRA) testimony in this proceeding. The valuation shall be performed by a qualified independent appraiser. Pacific and DRA shall each choose an appraiser to represent them; the two appraisers shall jointly choose the appraiser who will value ISG. The appraiser will be independent from both Pacific and DRA, but shall have full access to the ISG books, records, internal memoranda, and all supporting documentation, provided the appraiser has executed appropriate confidentiality agreements with Pacific. The valuation of ISG shall be calculated as of 60 days after the date of this decision. Pacific shall promptly file the appraisal with the Commission, within 30 days after its completion.

3. Pacific shall file an advice letter to reduce its rates, pursuant to Ordering Paragraph 2, by means of a surcredit, spread over one year. This advice letter shall be filed within 60 days after the appraisal is filed with the Commission. The surcredit shall be applied to intrastate access service, intraLATA toll (including private line) exchange, and exchange services. Interest shall accrue on this amount from the date of valuation until fully amortized through the surcredit ordered in this Ordering Paragraph. This interest shall be calculated at the 90-day commercial paper rate as published by the Federal Reserve Statistical Release and calculated consistent with the methodology used in annual sharable earnings filings.

4. Pacific shall impute fully allocated cost as described in Federal Communications Commission (FCC) Part 64 (47 CFR §§ 64.901, 64.902), as modified by this Commission, to services when pricing them at "full cost" under the transfer pricing rules.

5. Pacific shall revise the Telesis Guidelines to incorporate the terms and conditions required by this decision for its transactions with ISG and PBIS. The rules appended to DRA's brief are consistent with the terms of this decision and should be used as a standard.

The Telesis Guideline that waives compensation for proprietary information for corporate purposes is expressly disapproved.

A new guideline ensuring that ratepayers will not be adversely impacted as a result of the disclosure of intellectual property to an affiliate is adopted.

The resulting "Pacific/Category III Guidelines" shall be reviewed by the Commission Advisory and Compliance Division (CACD).

Once approved by CACD, the Pacific/Category III Guidelines will govern the transfer of goods and services between Pacific and any Category III below-the-line affiliate.

6. Pacific may transfer the personnel and assets of ISG to PBIS upon the following conditions:

a. Compliance with Ordering Paragraphs 4 and 5.

b. Pacific shall submit a plan to CACD and DRA in conformance with our affiliate transaction decision, Decision (D.) 87-12-067, 27 CPUC 2d 137, Ordering Paragraph 34, subpar. (l), (m), and (q), to track revenues received by an affiliate as the result of a referral by Pacific's employees or agents. The tracking plan shall be approved by CACD before the transfer of ISG can be effected.

c. Pacific and PBIS shall consent, in a letter addressed to the Director of the Commission Advisory and Compliance Division, to the tariffing of PBIS's services so long as the Commission shall so order.

7. The terms and conditions for transactions between Pacific and PBIS that are set forth in this decision are affirmed for every transaction between Pacific and an affiliate, except that

determining whether an asset shall be valued as a going concern, is subject to the circumstances of each case.

8. Pacific shall continue to conduct market pricing studies for non-tariffed goods or services it expects to provide to PBIS, except as follows:

> Market pricing studies are not required for goods or services which have an aggregate billing to all affiliates of less than $100,000 per year. Billings to Pacific and Nevada Bell shall not be counted toward the $100,000 threshold.
>
> Market pricing studies shall be completed no more than 180 days after the time Pacific reasonably discovers, or should have discovered, that the aggregate billing for the service in question has reached its $100,000 threshold.
>
> Pacific may use the Consumer Price Index Factor to annually update the market prices derived from the 13 studies it has already performed. A new market price study for each of those services will be due four years from the date of the original study, if PBIS is still being provided that service and the $100,000 threshold is met at that time.

9. Pacific shall identify its "critical or essential services" to PBIS as defined herein and develop a methodology consistent with D.87-12-067 for the market pricing of those services. Pacific shall not provide non-tariffed services to PBIS unless they are critical or essential services and are priced at the higher of either market price or fully allocated cost, as that term is defined under FCC Part 64, as modified by the Commission, plus 10%.

10. Pacific shall formalize its transfer pricing contracts for its services prior to offering them to PBIS or to any other affiliate.

11. Pacific shall inform the Commission of any new services or lines of business that PBIS plans to enter prior to their implementation.

12. Pacific's motion to strike portions of the opening and reply briefs of California Cable TV Association is granted.

13. The question of whether PBIS is subject to regulation as a public utility is reserved for a subsequent generic proceeding that would afford all interested parties an opportunity to be heard on the issue.

14. PBIS shall tariff all enhanced services it offers pending further consideration of the issue by the Commission in a generic proceeding. Tariffs shall be proposed by advice letter consistent with General Order 96-A, as modified by Ordering Paragraph 4 of D.89-10-031. Initial tariffs shall be filed no less than 40 days before the date on which PBIS intends to offer the enhanced service to any customer, including Pacific.

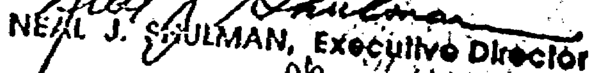
15. Pacific shall comply with the requirements set forth in Findings of Fact 49, 55, 69, and 70.

This order is effective today.

Dated July 22, 1992, at San Francisco, California.

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

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



NEAL J. SHULMAN, Executive Director