

SEP 4 1992

Decision 92-09-044 September 2, 1992

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of )  
 Pacific Bell, a corporation, for )  
 authority to increase certain )  
 intrastate rates and charges )  
 applicable to telephone services )  
 furnished within the State of )  
 California. )

---

Application 85-01-034  
 (Filed January 22, 1985;  
 amended June 17, 1985, and  
 May 19, 1986)

And Related Matters.  
 (Telesis Audit Phase)

---

I.85-03-078  
 (Filed March 20, 1985)  
 OII 84  
 (Filed December 2, 1980)  
 Case 86-11-028  
 (Filed November 17, 1986)

(See Appendix A for appearances.)

I N D E X

<u>Subject</u>	<u>Page</u>
OPINION .....	2
1. Summary .....	2
2. Introduction .....	2
3. Public Packet Switching Issues .....	4
4. Recovery of Protocol Conversion Costs .....	5
5. Analysis of Relevant Decisions .....	7
5.1 D.86-01-026, the Post-Divestiture Rate Order ..	7
5.2 D.87-12-067, the Phase 2 Rate Decision .....	8
5.3 Was Public Packet Switching Subject to Refund? .....	9
5.4 Ratemaking Treatment for Other Services .....	10
5.5 Public Packet Switching Resolution T-11070 .....	12
5.6 Modification in Response to Pacific Bell Protest .....	14
5.7 Resolution T-13026 Extending Packet Service Tariff .....	15
5.8 Reclassification of Packet Switching in D.90-05-045 .....	17
6. Analysis of Prior Decisions .....	19
6.1 Deferral of Packet Switching Refunds .....	20
6.2 Parallel Track .....	20
6.3 Distinguishing Factors .....	21
7. 1990 Prospective Costs .....	23
8. Other Issues .....	24
9. Conclusion .....	24
Findings of Fact .....	25
Conclusions of Law .....	26
ORDER .....	27
Appendix A	

O P I N I O N

1. Summary

We conclude that the treatment of research and development costs for the public packet switching service offered by Pacific Bell is consistent, under the new regulatory framework, with the treatment of such costs for other new services offered by the utility. Accordingly, no refund for ratepayer contributions for public packet switching is justified. However, we require a refund to ratepayers of \$2.253 million, plus interest, for research and development costs of protocol conversion, the enhanced service portion of public packet switching, since rates for that product were authorized subject to refund pending a decision on whether the product would become part of rate base.

2. Introduction

We turn now to the final issue in the Telesis Audit Phase of Application (A.) 85-01-034.

In Decision (D.) 92-07-076, dated July 22, 1992, we approved and adopted a settlement agreement between the Division of Ratepayer Advocates (DRA) and Pacific Bell resolving most of the issues in the five-year-old Pacific Telesis Audit. The audit concluded that Pacific Telesis and Pacific Bell had used ratepayer funds to subsidize competitive products or unregulated activities in the areas of research and development, joint ventures and strategic alliances.<sup>1</sup> Pacific Bell denies that any unlawful subsidy took place.

We rejected the parties' first proposed settlement agreement on the basis that it failed to adequately address an

---

<sup>1</sup> See Report on the Research and Development, Joint Ventures, and Strategic Alliances of Pacific Bell and Pacific Telesis Company, A.85-01-034, by DRA, Telecommunications Operational Cost Branch, dated October 30, 1990.

audit recommendation for a refund of some \$37 million annually for alleged cross-subsidies of five competitive products.<sup>2</sup>

DRA and Pacific Bell subsequently proposed, and we approved, a second settlement agreement. That settlement implements new procedures for tracking and allocating product development costs so that ratepayers do not subsidize non-regulated activities. The settlement also requires that Pacific Bell refund to customers approximately \$45 million (calculated at \$19.1 million annually, plus interest, since January 1, 1990), and requires a prospective reduction in rates of \$19.1 million thereafter. The date of January 1, 1990, was selected because that is when Pacific Bell implemented rates based on our new regulatory framework decision (D.89-10-031).<sup>3</sup>

The settling parties left for subsequent briefing and later decision one issue that we had raised in disapproving the first settlement proposal. That issue is:

Should a refund be required for public packet switching development costs, and what legal issues are posed by the seeming inconsistent treatment of these products' costs in our decisions in<sup>4</sup> D.90-05-045, D.87-12-067, and D.86-01-026?

As to public packet switching, DRA and Pacific Bell proposed, and we agreed, that this matter be set for briefing and for later disposition on the merits. At a prehearing conference on

---

2 D.91-11-023, dated November 6, 1991.

3 The settlement provides that DRA and other parties may continue to pursue ratepayer refunds for the period 1986-1989 as part of the proceeding in A.90-12-052 (Application of Pacific Bell for Authorization to Transfer Specified Personnel and Assets).

4 D.91-11-023, Ordering Paragraph 3.d. See also, the Commission's discussion of this question at footnote 18 and at pp. 25-26 of D.91-11-023.

February 21, 1992, the parties were directed to file briefs on the public packet switching issue by March 30, 1992, with replies due April 15, 1992. Only two parties (DRA and Pacific Bell) chose to file briefs and replies. AT&T Communications of California, Inc. (AT&T) served a letter commenting on the public packet switching issue.

### 3. Public Packet Switching Issues

The "seeming inconsistent treatment" upon which we focused in D.91-11-023 may be stated as follows:

Were Commission decisions requiring that rates for competitive services be subject to refund pending Telesis Audit results intended to include the public packet switching service, and did the Commission's decision addressing public packet switching in D.90-05-045 resolve all refund issues with respect to this service?

DRA takes the position that the Commission since 1986 has set Pacific Bell rates "subject to refund" as to matters to be addressed in the Telesis Audit. Further, DRA states, the Commission has criticized Pacific Bell for discovery tactics that blocked completion of the audit report (the Audit Report) until October 30, 1990. While D.90-05-045 dealt specifically with public packet switching and did not require refunds of past subsidies, that decision was issued on May 4, 1990--before the audit results were known--and impliedly retained (or at least did not nullify) the "subject to refund" status of public packet switching included in decisions dealing with the DRA Audit.

Pacific Bell argues that the Commission's decisions never identified public packet switching as one of the matters with rates subject to refund. Even if it had, the utility states, the Commission reviewed this product and, in D.90-05-045, determined as a conclusion of law that "Pacific should not be required to refund

to ratepayers past expenditures associated with PPS services."<sup>5</sup> Unlike other products identified in the Audit Report, Pacific Bell states, public packet switching was independently investigated and the issues that it raised (including ratepayer refunds) were resolved in D.90-05-045. Pacific Bell argues that, in the face of that decision, a public packet switching refund now would constitute retroactive ratemaking, and that DRA's attack on that decision is barred by the doctrine of collateral estoppel and by Public Utilities (PU) Code § 1709.<sup>6</sup>

AT&T--the only other party to submit comments in this examination of public packet switching<sup>7</sup>--supports the conclusion reached by Pacific Bell. AT&T states that Telesis Audit decisions (which it identifies as D.86-01-026 and D.87-12-067) and the public packet switching decisions (which it identifies as Resolution T-11070, dated November 5, 1986; D.87-03-087; Resolution T-13026, dated November 3, 1988; and D.90-05-045) ran on parallel tracks and were separately resolved.

#### 4. Recovery of Protocol Conversion Costs

We turn first to a matter upon which the parties agree. DRA states that protocol conversion (which is the enhanced service portion of public packet switching) was addressed in our new regulatory framework decision (D.89-10-031) and moved below the

---

5 D.90-05-045, Conclusion of Law 4, p. 10.

6 PU Code § 1709 states: "In all collateral actions or proceedings, the orders and decisions of the commission which have become final shall be conclusive."

7 Five parties submitted briefs in connection with the original settlement proposal. DRA and Pacific Bell argued in favor of their settlement; the settlement was opposed by Toward Utility Rate Normalization (TURN), AT&T, and MCI Telecommunications Corporation (MCI). Only one party, the California Cable Television Association (CCTA), filed comments objecting to the second settlement proposal. TURN, MCI, and CCTA have not submitted comments on the public packet switching issue now before us.

line for ratemaking purposes. (33 CPUC2d 43, 145.) Pacific Bell, however, did not adjust its start-up revenue requirement to account for protocol conversion being moved below the line. Accordingly, costs for protocol conversion were included in Pacific Bell's start-up revenue requirement for 1990. This amount, DRA states, should be refunded to ratepayers based on the reasoning set forth in the parties' settlement agreement and in our order in D.91-11-023.

Pacific Bell agrees. Although it states that an argument could be made that our packet switching decision (D.90-05-045) includes all packet switching products, including protocol conversion, it acknowledges the similarities between protocol conversion and other enhanced services covered by the settlement agreement. Pacific Bell did not remove protocol conversion costs from rates until January 1, 1991, when it removed the packet switching costs from rates pursuant to D.90-05-045. (See, Resolution T-14235, dated December 19, 1990.)

DRA and Pacific Bell agree that the amount included in revenue requirements for 1990 for protocol conversion was \$2.253 million.<sup>8</sup> The parties propose a one-time rate reduction in this amount for protocol conversion expenses recovered in rates between January 1, 1990, and December 31, 1990, plus interest.

We agree that a refund for protocol conversion costs is appropriate. Our order today requires a refund to ratepayers of \$2.253 million, plus interest. We believe that protocol conversion was dealt with in our decisions in a manner that was identical to our dealing with voice mail, electronic messaging and voice store/forward. We do not agree with Pacific Bell that our packet

---

<sup>8</sup> DRA originally calculated the amount included in the start-up revenue requirement at \$1.5 million. Pacific Bell stated that the correct amount was \$2.253 million. Following consultation and review, DRA amended its calculation to match that of Pacific Bell.

switching decision (D.90-05-045) can be interpreted to include protocol conversion as part of the basic packet switching service that was addressed in that and prior decisions. In the discussion that follows, we continue to address the basic packet switching service as separate, for ratemaking purposes, from protocol conversion.

#### 5. Analysis of Relevant Decisions

All parties agree that public packet switching was singled out for examination by the Commission. Therefore, our analysis reviews those decisions that deal with product costs deemed subject to refund pending the Audit Report, and with those decisions that dealt separately with public packet switching.

##### 5.1 D.86-01-026, the Post-Divestiture Rate Order

D.86-01-026 (20 CPUC2d 237) was the first general rate decision issued following the 1982 consent decree that severed the seven regional Bell operating companies from AT&T.<sup>9</sup> While that decision resolved most of the issues related to Pacific's revenue requests (ordering, among other things, a \$123.8 million reduction in rates), it reserved eight issues for consideration in a Phase 2 proceeding. One of those issues was:

"6. The results of staff's completed audit of PacBell's transactions with affiliates in the Telesis Group and Staff's analysis of PacBell's San Ramon Valley complex." (20 PUC2d 237, 251-52.)

While citing testimony that Pacific Bell personnel had been generally cooperative in the audit, the Commission expressed displeasure at the reluctance of Telesis Group affiliates to cooperate in the audit. To "put a price on our displeasure," the Commission reduced Pacific Bell's gross revenue requirement by

---

<sup>9</sup> United States v. American Tel. & Tel. Co., 552 F.Supp. 131 (D.D.C. 1982), aff'd sub nom. Maryland v. United States, 460 U.S. 1001, 103 S.Ct. 1240, 75 L.Ed.2d 472 (1983).

\$4 million pending completion of the audit. (20 CPUC2d 237, 261.) This \$4 million holdback remains in place today, although it will be lifted as a result of the recent settlement.

Since further proceedings were contemplated, the Commission ordered that Pacific Bell's "intrastate rates and charges shall be collected subject to refund back to January 1, 1986 in view of the further reductions in revenue requirements which could result depending on the outcome of issues to be addressed in the next phase of these proceedings." (20 CPUC2d 237, 355.) As noted, the Telesis Audit was one of the issues reserved for further hearings.

5.2 D.87-12-067, the Phase 2 Rate Decision

D.87-12-067, issued on December 22, 1987, was the Phase 2 decision in Pacific Bell's rate application. The Commission resolved many of the issues, including audit issues, that earlier had been reserved. (27 CPUC2d 1, 162.) It agreed with DRA that the audit should continue in "the important areas of joint ventures, strategic alliances, and research and development projects" among Telesis Group affiliates. (27 CPUC2d 1, 101.) Accordingly, it kept in place the \$4 million disallowance and repeated its "subject to refund" directive, stating:

"Pacific Bell's intrastate rates and charges shall remain subject to refund back to the effective date of D.86-03-049 in view of the further reductions in revenue requirements which could result depending upon the outcome of the specified issues originally reserved for Phase 2 review, to be further addressed in the next phase of these proceedings." (27 CPUC2d 1, 163.)

The decision also included a lengthy analysis of matters raised by the DRA audit up to that time (27 CPUC2d 1, 96-141). We adopted 21 audit recommendations (27 CPUC2d 1, 162-63), including disallowances for affiliate referral fees, transferred employee fees and gain on sale of property, but we

declined to adopt DRA's proposed 5% "royalty" fee for intangible benefits received by affiliated companies. As to the \$4 million disallowance pending completion of the audit, we said:

"Since the work of the auditors is not complete, we believe it is appropriate to keep the \$4 million revenue requirement adjustment in place pending completion of this further audit. The adjustment, first imposed after Phase 1 in D.86-01-026, due to noncooperation with the auditors' efforts, should remain in place until the auditors' efforts have concluded. Our experience in Phase 2, while not on a par with the episodes recited in D.86-01-026, leads us to conclude that the contentious environment surrounding the auditors' work hampered the development of the record." (27 CPUC2d 1, 140.)

We ordered the audit completed in three months. Because of further discovery disputes, the audit in fact was not completed until October 30, 1990--almost three years later.<sup>10</sup>

### 5.3 Was Public Packet Switching Subject to Refund?

Pacific Bell argues that none of the eight issues set forth in the Phase 1 decision listed public packet switching, and therefore the "subject to refund" provisions both in Phase 1 and Phase 2 decisions could not have included costs for that research and development project. It seizes upon our direction that we would reserve, pending audit, the issue of "PacBell's transactions with affiliates in the Telesis Group," stating that packet switching does not involve transactions with affiliates. DRA responds that Pacific Bell knew or should have known that research and development costs of new products and services were subject to refund because of the Commission's direction in the Phase 2

---

<sup>10</sup> The discovery disputes that dogged the audit process are described in D.91-11-023, pp. 19-22.

decision for completion of the audit "of joint ventures, strategic alliances and R&D projects."

We agree with DRA. Our decision to reserve consideration of subsidy of competitive products was based on an absence of information. The absence of information was caused in large measure by the tactics of Telesis Group affiliates in attempting to avoid DRA audit requests. (20 CPUC2d 237, 261.) If a utility and its affiliates deny information to the Commission, the utility will not later be heard to object to a Commission order on the basis that a matter clearly within the scope of the issues related to the missing information was not explicitly stated in the order. Under the circumstances, we believe that a broad interpretation of the "subject to refund" provisions is fully justified.

#### 5.4 Ratemaking Treatment for Other Services

Before reaching a conclusion on public packet switching costs, we must examine ratemaking treatment accorded other services for which the DRA Audit Report recommended refunds.

In three decisions in 1988 and 1989, the Commission authorized Pacific Bell to provide a number of enhanced services, including protocol conversion, voice mail, electronic messaging, and voice store/forward services (D.88-11-027, D.89-05-020, and D.89-09-049). Each of these decisions required Pacific Bell to establish memorandum accounts to track expenses for the service. Each decision reserved the issue of whether these costs were to be treated above the line (that is, included in rates) or below the line (that is, not included in rates).

Since the Commission deferred the decision on whether these costs would be booked above or below the line, costs of the services were made subject to refund in identical language in the ordering paragraphs:

- "4. All of Pacific's rates subject to regulation (including rates subject to potential regulation contingent on the outcome of judicial appeal) from the effective date of this decision forward are subject to refund

based on ratemaking adjustments as a result of the final disposition of the issue of whether some or all of Pacific's enhanced services should be accounted for above or below the line."<sup>11</sup>

In the new regulatory framework decision (D.89-10-031), issued on October 12, 1989, the Commission adopted incentive-based regulation, centered on a price cap indexing mechanism that provides for sharing between ratepayers and shareholders of excess earnings above benchmark rates of return. As part of this, we determined that protocol conversion, voice mail, electronic messaging, and voice store/forward services should be placed below the line as Category III services. Several findings of fact in the new regulatory framework decision explain the Commission's reasoning in deciding that shareholders, not ratepayers, should bear the risk and reap the rewards of developing these enhanced services:

"71. Risks, costs, and benefits to basic ratepayers, potential harm to competitive markets, similarity to services in the sharing mechanism, and ability to separate a service's costs and revenues from other utility operations are relevant factors to consider in deciding whether a service should be included in the basic sharing mechanism."

\* \* \*

"73. Pacific has been granted interim authority to offer four enhanced services: protocol conversion, voice mail, electronic messaging, and voice store and forward services. Since these services have been preemptively detariffed by the FCC, Pacific has the maximum flexibility allowed by law for these services."

\* \* \*

---

<sup>11</sup> The subject to refund provision is Ordering Paragraph 4 in D.88-11-027, 29 CPUC2d 479, 484; D.89-05-020, 31 CPUC2d 591, 597; and D.89-09-049, 32 CPUC2d 445, 457.

"77. Below-the-line treatment for the four enhanced services currently authorized would maximize incentives for Pacific to compete vigorously in development of these new services and would protect both ratepayers and competitors by preventing cross-subsidies from basic services." (33 CPUC2d 43, 218.)

With the decision to place these products below the line (that is, to remove the costs of these products from rate base and remove the revenue from the sharing mechanism), the stage was set for considering the recommendations of the Audit Report. The report urged refunds of \$37 million to cover costs of the enhanced products discussed above, as well as public packet switching. DRA argued that authorization for all of these products except packet switching had been made subject to refund, and that D.86-01-026 had made all such rates subject to refund until the audit was complete. For those products now classified below the line, DRA maintained that our decisions require that shareholders, not ratepayers, bear past and future development costs. DRA maintains that essentially the same reasoning applies to public packet switching.

Unlike the other products, packet switching is not analyzed in D.89-10-031. We turn then to those Commission decisions that reviewed this service.<sup>12</sup>

#### 5.5 Public Packet Switching Resolution T-11070

Resolution T-11070, dated November 5, 1986, authorized Pacific Bell to file tariffs for an intrastate public packet switching service on a 24-month basis. The authority was granted over the protests of Telenet Communications Corporation (Telenet)

---

<sup>12</sup> These decisions are Resolution T-11070, dated November 5, 1986; D.87-03-087, dated March 25, 1987; Resolution T-13026, dated October 26, 1988; D.90-05-045, dated May 4, 1990; and Resolution T-14235, dated December 19, 1990.

and Tymnet-McDonnell Douglas Network Systems Company (Tymnet), which operate extensive interstate packet switched networks.

The Commission noted that packet switching of data records has been performed on government and private data networks since the 1960s. Packet switching is a technique for sending data in groups of "packets," usually in sizes of 128 or 256 characters per packet. In addition to the data, there are embedded source and destination codes and elaborate error checking parameters. The technique is considered an efficient and highly reliable method for transmitting large amounts of data.

Until 1986, commercial packet switching networks were interstate in scope, and tariffs were filed with the FCC. Telenet, Tymnet and AT&T were among firms with extensive interstate packet switched networks. Since divestiture from AT&T, the regional Bell operating companies have begun local area data transport networks to handle packet switched data communications within their operating territories.

The Commission reasoned that, based on information then available, earnings from packet switching appeared likely to exceed costs, thus benefiting ratepayers. In its ordering paragraphs, the Commission instructed Pacific Bell to consider increasing rates for the service if packet switching did not show a profit during the trial period. Significantly, the only suggestion in the resolution that costs were to be treated any differently than those of other basic services came in the following summation:

"The rates for basic Public Packet Switching Service have been based on, for the most part, forecasted demand. Pacific may not have accurately predicted the cost, revenue, and profitability of this new offering. Therefore, we shall reserve judgment on the permanent approval of this service and shall authorize a provisional offering to test the rate structure and to substantiate the cost, revenue and profitability of this service. Based on the data obtained from this trial, the basic Public Packet Switching Service scheduled to expire on

November 5, 1988, may be implemented permanently, changed, extended or withdrawn by Pacific Bell subject to Commission authorization. In any case it should be clearly understood that if this service turns out not to be profitable, the stockholders, and not the ratepayers, shall assume all risks and be responsible for any losses." (Resolution T-11070, p. 2, prior to amendment. Emphasis added.)

The highlighted sentence in that summation--suggesting that costs for the service would be borne by shareholders--was deleted and replaced five months later in D.87-03-087 following Pacific Bell's application for rehearing.

#### 5.6 Modification in Response to Pacific Bell Protest

Pacific Bell postponed implementation of public packet switching in order to protest the "stockholder risk" statement in Resolution T-11070. The utility objected that the statement appeared to suggest that shareholders must bear the burden of any loss should the service be unprofitable, while any profit would inure to the benefit of the ratepayers. It argued that such an interpretation violates traditional ratemaking principles, in which risk of loss follows the chance for profit,<sup>13</sup> and it urged the Commission to allocate both profits and any loss either to the ratepayers, or to shareholders. It requested authority to withdraw the switching service if the "stockholder risk" statement remained unchanged.

In D.87-03-087, dated March 25, 1987, the Commission stated that it did not intend to depart from the philosophy that risks ought to be taken by those who stand to profit from them. It conceded, however, "that T-11070 may easily be read that way." Accordingly, the Commission deleted the "stockholder risk"

---

<sup>13</sup> Pacific Bell cited Board of Public Utility Commissioners, et al. v. New York Telephone Company (1926) 271 U.S. 23.

statement from Resolution T-11070 and substituted alternative language suggested by the Public Staff Division. The substitute language states:

"...In accord with this Commission's long established ratemaking policies, the Commission will carefully examine any questions relating to the profitability of this service or the prudence of management's actions in any rate proceeding where this service may affect the rates of other customers." (D.87-03-087, p. 3.)

The Commission explained that "shareholders are to be held responsible for only those losses which we find, in the next general rate case, to be traceable to imprudent business decisions on the part of their management." (D.87-03-087, p. 2.)

As of March 1987, therefore, the Commission had made it clear that packet switching was a basic service, and that its plant and other costs were to be treated like those of any other basic service--that is, included in rates. Profits from the service, if any, would be reflected in utility income.

#### 5.7 Resolution T-13026 Extending Packet Service Tariff

Pacific Bell continued to develop and market its version of packet switching for the next year and a half. By the end of that time, both the utility and Commission staff realized that the service was not likely to become profitable in the near future.

Because the packet service tariffs had been authorized for only two years, Pacific Bell on October 3, 1988, sought a one-year extension of its authority, along with authority to increase usage rates and add call forwarding features to the service. The Commission approved the utility's request, with modifications. The Commission stated:

"[The Commission] [o]rders hearings on the viability of Pacific's PPS Service. Said hearings shall be consolidated with A.88-08-031, Pacific's application for enhanced services. In the interim, the provisional tariff is extended to an indefinite future date

which will be determined in the Commission's decision on A.88-08-031. Pacific's provisional tariff for PPS, which is considered basic service by the Federal Communications Commission (FCC), has little chance of becoming a viable service offering (i.e. compensatory) without the provision of protocol conversions classified as enhanced services by the FCC. The pricing of packet switching will be reviewed during the hearings to determine if and under what conditions PPS Service should be continued." (Resolution T-13026, pp. 1-2. Emphasis added.)

Packet switching used a protocol conversion (that is, a communications system) that was relatively limited. In part because of that, Pacific Bell's packet switching service had attracted only nine customers and was not showing a profit. However, Pacific Bell urged an extension of its tariff so that it could add enhanced protocol conversions on a non-tariffed basis, making the service attractive to a larger customer base, and justifying increased rates.

In ordering hearings on the viability of public packet switching, the Commission commented on costs already incurred in developing the service and the possibility of cutting those losses by disallowing extension of the tariffed service. The Commission said, in part:

"The provisional tariff allowed the Commission to reserve judgment on a permanent approval of the service offering so that Pacific could test the rate structure, and substantiate the cost, revenue and profitability of PPS Service. The Commission wanted to give Pacific every opportunity to demonstrate the service was compensatory because Pacific had spent large sums of money implementing and testing the service without Commission approval, and much of the new plant was in rate base and was being paid for by the California ratepayers.

\* \* \*

"Although there is some question as to whether Pacific's basic PPS Service would be viable if it added the Net Protocol Conversion, there can be no question that PPS Service will not be compensatory at this time without it. The offering of Net Protocol Conversion (enhanced service), however, is part of Pacific's pending Application No. 88-08-031 on enhanced services. Application A.88-08-031 will consider the major regulatory policy issues that will arise in regard to deployment of enhanced services....

\* \* \*

"Until a decision is reached in A.88-08-031 on Pacific's PPS Service, Pacific will be allowed to continue offering the service. It would be premature to have the provisional tariff expire without further investigation, because packet switching is a service that will be used in future enhanced offerings such as electronic mail, ISDN (Integrated Switched Digital Network), etc....." (Resolution T-13026, pp. 7-8.)

As of October 1988, therefore, the Commission had granted an indefinite extension of the earlier packet switching tariff. There was no change in the ruling of D.87-03-087 that the service would continue to be a basic one, with costs included in rates. Whether the service should continue to be a basic one, and whether costs should continue to be borne by ratepayers, was made subject to further hearings.

#### 5.8 Reclassification of Packet Switching in D.90-05-045

D.90-05-045, issued May 4, 1990, granted Pacific Bell authority to continue to provide public packet switching services. However, it reclassified the service from Category I (regulated service) to Category III (competitive service) and it required that costs for the service be moved below the line so that risks of packet switching would be borne by shareholders, not ratepayers.

The decision followed five days of hearings. Briefs were filed by four parties, including DRA.

The Commission agreed with DRA that Pacific Bell had failed to show that its packet switching service was likely to be profitable at any time in the near future. While the utility's forecasts showed strong demand for the service, the projections did "not appear to have accounted for the fact that Pacific's product is not comparable to those of other firms because it has a limited number of protocols and is not offered statewide." (D.90-05-045, p. 2.)

In directing that packet switching be changed from a basic monopoly service (Category I) to a below-the-line Category III service, the Commission relied upon the criteria developed in the new regulatory framework decision, D.89-10-031. While that decision included packet switching as a Category I service subject to the sharing mechanism, it added that "we may reconsider its treatment in A.88-08-031." (33 CPUC2d 43, 147.) In D.90-05-045, the Commission said:

"We conclude in this case that Pacific's ratepayers should not assume the risk associated with PPS services. Pacific is likely to make better investment and marketing decisions if PPS is treated 'below-the-line,' that is, not included in regulated accounts. Under our new regulatory framework adopted in D.89-10-031, PPS services would therefore not be subject to the 'sharing' mechanism under which ratepayers and shareholders share the profits and losses when Pacific's returns fall outside a designated band.

"We also believe that PPS services should be considered a Category III service. As defined by D.89-10-031, a Category III service is one that is afforded the maximum pricing flexibility allowed by law. PPS is suited to such treatment since, as the record shows, it is one over which Pacific has no market power." (D.90-05-045, p. 6.)

Having concluded that Category III classification was proper, the Commission turned next to the treatment of past

expenditures for packet switching. First, we discounted the utility's argument that the Commission earlier had disallowed costs that arguably represented those for packet switching. We concluded that ratepayers had funded development costs of the service, but we found also that a refund of these past costs was not appropriate, stating:

"D.89-10-031 addressed the issue of past expenditures for competitive services. The decision rejected DRA and TURN's proposal to identify and return to ratepayers such expenditures. In this case, no party has proposed that Pacific's rates be reduced to reflect the past expenditures associated with PPS which may have been included in rates. It is an option we would hesitate to adopt in light of the new regulatory program put into place by D.89-10-031. Further, PPS plant should not be greatly depreciated at this point, so that past ratepayer contributions are unlikely to significantly distort current cost estimates or prices." (D.90-05-045, pp. 7-8.)

DRA had taken the position in this case that packet switching should remain a Category I service, apparently because it believed that packet switching met the criteria for basic service. In a concurring opinion in D.90-05-045, Commissioner Ohanian observed that packet switching was likely to play an increasing role in utility service, particularly as Pacific Bell moved to an all-digital public telephone network. He suggested that the Commission at some later time may reconsider classification of packet switching and move it back into Category I or into Category II. (D.90-05-045, concurring opinion.)

#### 6. Analysis of Prior Decisions

Having reviewed the decisions dealing with refund of ratepayer contributions to products identified in the DRA Audit Report, we turn now to the question of whether refunds are or should be required for Pacific Bell's public packet switching service.

### 6.1 Deferral of Packet Switching Refunds

First, DRA argues that the packet switching decision (D.90-05-045) "deferred" the issue of refund of past ratepayer subsidy of packet switching development. In support of that, it notes the Commission's statement that, in the future, "we may consider other ways to treat cost and revenues when a service is moved out of the 'sharing' mechanism." (D.90-05-045, p. 8.) Since the Audit Report followed the packet switching decision, and since earlier rates for competitive products examined in the audit had been made subject to refund, DRA states that the Commission now may consider the refunds that had been deferred in D.90-05-045.

We conclude that no reading of D.90-05-045 can support an interpretation that the refund issue was deferred. The reference to alternatives in treating costs and revenues is addressed to the method by which future costs, not past costs, are to be removed from ratemaking. Indeed, the reference relied upon by DRA follows and relates to this unequivocal statement:

"Although we decline to require Pacific to reimburse ratepayers for past expenditures, we will require Pacific to reduce its rates so that ratepayers do not subsidize PPS services going forward. (D.90-05-045, pp. 7-8. Emphasis added.)"

Even if the text of the decision left any doubt about the issue of refunds to ratepayers for packet switching, any such doubt is removed by the decision's Conclusion of Law 4, which states:

"4. Pacific should not be required to refund to ratepayers past expenditures associated with PPS services." (D.90-05-045, p. 10.)

### 6.2 Parallel Track

We also decline to follow the suggestion of AT&T that the packet switching decisions discussed above ran a parallel and separate track from those decisions dealing with the Telesis Audit. The suggestion of a parallel track begs the question. What we are examining is whether there is inconsistent treatment of product

development costs. If all factors are equal, then product consideration on different tracks should still reach the same result.

### 6.3 Distinguishing Factors

Our review of the relevant cases shows that the Commission's actions with respect to ratepayer refunds have been consistent with the approach adopted in the new regulatory framework decision (D.89-10-031). In all of these cases, the Commission has first sought to determine whether a new service should or should not be categorized as basic to utility service and thus included in rate base. If it is determined that a new service belongs in rate base, then our inquiry as to refunds is at an end. No question of ratepayer refunds arises. On the other hand, if it is determined that a new product is a competitive one that should be offered below the line, then we must proceed to deal with past and future ratepayer subsidy of that product. Finally, if we reach no immediate decision on how to categorize a new product, then we must consider whether to make costs subject to refund pending a later decision on whether to treat the product above or below the line.

As noted in the new regulatory framework decision, the criteria to be used in evaluating a new Pacific Bell service include the risks, costs, and benefits of the service to basic ratepayers, the potential harm to competitive markets of including costs in rates, the similarity of the new service to services already in the sharing mechanism, and the practical assessment of separating a product's costs and revenues from other utility operations. (See, D.89-10-031, Finding of Fact 71.)

This general approach was followed in the decisions addressing four of services examined in the DRA Audit Report-- protocol conversion, voice mail, electronic messaging, and voice store/forward services. In those decisions (D.88-11-027, D.89-05-020, and D.89-09-049), we determined that these were

relatively new services, with little similarity to services already in the sharing mechanism. Each service was likely to face competition in the marketplace. Because of the pendency of the new regulatory framework proceeding, we deferred decision on categorizing the new products, but we signaled our preliminary assessment by requiring memorandum accounts to track product development costs, and by making rates subject to refund if and when we later determined that the products should be developed below the line.

By contrast, our decisions in the packet switching cases assumed from the start that this was a basic service. It had been offered for more than 20 years. It potentially could benefit ratepayers. The tariff for the service was extended on an open-ended basis without change in the determination that costs (and profits, if any) would be reflected in rates. It was only when we were confronted with evidence that this service was not measuring up to the criteria for rate treatment that we decided (in D.90-05-045) to change the product designation from Category I to Category III so that ratepayers would not be at further risk.

It follows then that the issue of refund of past ratepayer contributions for public packet switching simply did not arise, since our prior decisions had included this service in rates without reservation. We did not defer a decision on rate base treatment. We made the decision. Later, on the basis of additional evidence, we made a subsequent decision to change treatment of this service to remove it from rate base. The "subject to refund" requirement attached to the audit in Pacific Bell's 1986 rate proceeding therefore ceased to apply to past funding of public packet switching, because that requirement applied only to services not properly included in rates.

In summary, we conclude that the "subject to refund" provisions in our decisions dealing with the Audit Report were sufficiently broad to consider the rates assessed for public packet

switching. We also find, however, that these provisions were applicable only when product costs had improperly been included in rate base, or when authorization for a new service had expressly reserved the decision on whether costs should be treated above or below the line. When the Commission directed without reservation that packet switching costs be recorded above the line, there was no basis upon which to require the utility to refund past costs to ratepayers.

#### 7. 1990 Prospective Costs

DRA states that D.90-05-045 permitted Pacific Bell to retain \$2.43 million in development costs for packet switching for May-December 1990, since the order provided that cost adjustments be included in the "Z factor" adjustment<sup>14</sup> at year end. It urges refund of this amount, since it represents prospective costs after our decision to move packet switching out of rate base.

There is merit in DRA's argument. It is clear that the Commission wrestled with this question in D.90-05-045, commenting that "(t)he procedure we apply to PPS for removing costs from rates is adopted in recognition that this issue and the PPS accounts existed prior to D.89-10-031. In the future, we may consider other ways to treat costs and revenues when a service is moved out of the 'sharing' mechanism." (D.90-05-045, p. 8.)

On the other hand, the use of a Z factor adjustment is a familiar one for removing costs from rates. No party objected to this procedure. No objection was filed in Resolution T-14235 (December 19, 1990) implementing the change. Since no memorandum account was ordered for this product, identification of costs and revenues was not clear-cut. Indeed, the utility argued that costs

---

14 The Z factor is part of the price cap index formula adopted in the new regulatory framework decision, D.89-10-031. It represents annualized dollar effect of specified cost changes. (See, 33 CPUC2d 43, 161, et seq.)

attributable to packet switching had been disallowed in its rate review. (D.90-05-045, p. 7.)

In short, we believe that use of the Z factor adjustment was a reasonable one in view of the circumstances of this service. In the future, however, we will consider other means of eliminating future costs of a product that has been moved out of rates. Even if, in hindsight, we were to decide that these costs should not have remained in rates after a Category III designation, we agree with Pacific Bell that these two final orders of the Commission (D.90-05-045 and Resolution T-14235) are conclusive and cannot in this collateral proceeding be attacked or modified by virtue of PU Code § 1709. Both Commission and court decisions have recognized the applicability of collateral estoppel to Commission decisions.<sup>15</sup>

#### 8. Other Issues

Since we have decided that our decision dealing with public packet switching is consistent with our decisions dealing with the Pacific Telesis Audit, there is no need for us to consider Pacific Bell's further arguments dealing with retroactive ratemaking or with broad application of the doctrine of collateral estoppel.

#### 9. Conclusion

The treatment of product costs in our decision in D.90-05-045 is consistent with our treatment of costs for other products in D.87-12-067 and D.86-01-026, and no refund of ratepayer contributions to Pacific Bell's public packet switching service is required. The "subject to refund" provisions of D.87-12-067 and D.86-01-026 are applicable to the protocol conversion portion of packet switching, and those costs should be refunded to ratepayers.

---

<sup>15</sup> See, People v. Simms (1982) 32 Cal.3d 468; Williams v. Tahoe Park Water Company (1991) D.91-09-017, pp. 6-7.

Findings of Fact

1. In D.91-11-023, we instructed the parties to address legal issues posed by the seeming inconsistent treatment of past product costs in our decisions in D.90-05-045, D.87-12-067, and D.86-01-026.

2. The parties agree that \$2.253 million, plus interest, should be refunded to ratepayers to reflect costs for protocol conversion, which was moved below the line in D.89-10-031.

3. Public packet switching service was examined by the Commission in Resolution T-11070, dated November 5, 1986; D.87-03-087; Resolution T-13026, dated November 3, 1988; D.90-05-045, and Resolution T-14235, dated December 19, 1990.

4. D.86-01-026, the Phase 1 decision in a Pacific Bell rate case, reserved eight issues for consideration in a Phase 2 decision, including the results of staff's completed audit of Pacific Bell's affiliates in the Telesis Group.

5. D.87-12-067, the Phase 2 decision in a Pacific Bell rate case, directed that the staff audit should continue in the areas of joint ventures, strategic alliances, and research and development projects.

6. D.87-12-067 directed that Pacific Bell rates would remain subject to refund pending completion of the staff audit.

7. The Commission authorized Pacific Bell to provide a number of enhanced services, including protocol conversion, voice mail, electronic messaging, and voice store/forward services, in D.88-11-027, D.89-05-020, and D.89-09-049.

8. D.88-11-027, D.89-05-020, and D.89-09-049 required the utility to establish memorandum accounts to track new services, reserved for later decision the issue of whether service costs would be treated above or below the line, and made rates subject to refund with respect to these services.

9. The new regulatory framework decision (D.89-10-039) moved protocol conversion, voice mail, electronic messaging, and voice store/forward services below the line as Category III services.

10. Resolution T-11070, dated November 5, 1986, authorized Pacific Bell to file tariffs for an intrastate public packet switching service on a 24-month provisional basis.

11. D.87-03-087 reaffirmed that costs for public packet switching were to be included in rates.

12. Resolution T-13026, dated October 26, 1988, extended the public packet switching tariff to an indefinite future date and ordered hearings on the viability of this service as part of A.88-08-031, Pacific Bell's application for enhanced services.

13. D.90-05-045 granted Pacific Bell provisional authority to continue to provide public packet switching services, but it reclassified the service from Category I to Category III.

14. D.90-05-045 found that Pacific Bell should not be required to refund to ratepayers past expenditures associated with public packet switching service.

#### Conclusions of Law

1. Pacific Bell should be required to refund to ratepayers \$2.253 million, plus interest, representing expenses for protocol conversion that were recovered in rates between January 1, 1990 and December 31, 1990.

2. The "subject to refund" provisions of D.86-01-026 and D.87-12-067 should be interpreted broadly to include consideration of research and development costs of public packet switching.

3. Resolution T-11070, dated November 5, 1986, and D.87-03-087 held that costs of public packet switching were to be included in rate base.

4. D.90-05-045 did not defer the issue of refund of past ratepayer subsidy of packet switching development.

5. Treatment of product costs in D.90-05-045 should be deemed to be consistent with the treatment of costs for other products in D.87-12-067 and D.86-01-026.

O R D E R

IT IS ORDERED that:

1. Pacific Bell is directed to refund to ratepayers \$2,253,000, plus interest, representing the amount for protocol conversion expenses recovered in rates between January 1, 1990 and December 31, 1990. Interest will be calculated based on the average Federal Reserve statistical release 90-day commercial paper rate in effect during the period.

2. To implement the refund described in Paragraph 1, Pacific Bell shall file an advice letter tariff filing, in accordance with General Order 96-A, on or before 60 days following the effective date of this order, with the refund to be applied as a surcredit under Pacific Bell's Rule No. 33, "Billing Surcharges." The refund amount shall be uniformly applied as a surcredit for local exchange (Rule 33, Part 1.A), intraLATA toll (Rule 33, Part 1.B), and access (Rule 33, Part 1.C) services.

3. Consistent with this decision, no refund of ratepayer contributions to costs of Pacific Bell's public packet switching service is required.

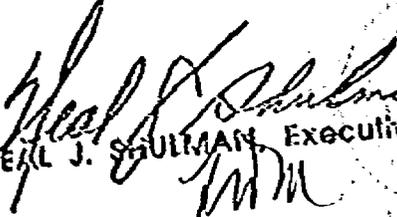
4. The Telesis Audit Phase of this proceeding is closed.

5. Application 85-01-034 is closed.  
This order becomes effective 30 days from today.  
Dated September 2, 1992, at San Francisco, California.

DANIEL Wm. PESSLER  
President  
JOHN B. OHANIAN  
NORMAN D. SHUMWAY  
Commissioners

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

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

  
NEIL J. SHULMAN, Executive Director

APPENDIX A  
Service List

Randolph W. Deutsche, Esq.  
AT & T COMMUNICATIONS OF  
CALIFORNIA, INC.  
795 Folsom Street, Rm. 625  
San Francisco, CA 94107

Jeffrey F. Beck, Atty. at Law  
BECK, YOUNG, FRENCH & ACKERMAN  
One Market Plaza  
1400 Steuart Tower  
San Francisco, CA 94105

Carrington F. Phillips, Esq.  
CA CABLE TELEVISION ASSOCIATION  
4342 Piedmont Avenue  
P.O. Box 17080  
Oakland, CA 94611

Kathleen S. Blunt, Esq.  
Judith A. Endejan, Esq.  
GTE CALIFORNIA, INC.  
1 GTE Place, CA500LB  
Thousand Oaks, CA 91362

Richard B. Severy  
MCI TELECOMMUNICATIONS CORP.  
201 Spear Street  
San Francisco, CA 94105

Gregory L. Castle, Atty at Law  
PACIFIC BELL  
140 New Montgomery St.,  
Room 1627  
San Francisco, CA 94105

Margaret deB. Brown, Atty. at Law  
PACIFIC TELESIS GROUP  
130 Kearny Street, Rm. 3659  
San Francisco, CA 94108

Earl Nicholas Selby, Esq.  
LAW OFFICES OF EARL  
NICHOLAS SELBY  
420 Florence Street, Suite 200  
Palo Alto, CA 94301

Robert J. Gloistein, Esq.  
ORRICK, HERRINGTON AND SUTCLIFFE  
400 Sansome Street  
San Francisco, CA 94111

Raymond W. Palmer  
TCS TELECOMMUNICATIONS SOLUTIONS  
220 Montgomery Street, Suite 484  
San Francisco, CA 94104.

Jerry O'Brien/Diane Martinez  
API SECURITY, INC.  
8550 Higuera Street  
Culver City, CA 90232

August A. Sairanen  
CALIFORNIA DEPARTMENT OF  
GENERAL SERVICES  
601 Sequoia Pacific Blvd., MS-12  
Sacramento, CA 95814-0282

Peter V. Allen  
CITY ATTORNEY'S OFFICE  
525 "B" Street  
Suite 2100  
San Diego, CA 92101

R. Fellmeth/J. Wheaton, Esqs.  
CENTER FOR PUBLIC INTEREST LAW  
University of San Diego, School  
Of Law - Alcala Park  
San Diego, CA 92110

Ellen S. Deutsch, Esq.  
CITIZENS UTILITIES CO OF CA  
1035 Placer Street  
P.O. Box 496020  
Redding, CA 96049-6020

Virginia Jarrow  
CONSUMERS COALITION OF CALIFORNIA  
1109 Barbara Street, #A  
Redondo Beach, CA 90277

William G. Irving  
LOS ANGELES COUNTY INFORMATION  
TECHNOLOGY SERVICE  
9150 East Imperial Highway  
Downey, CA 90242

Thomas J. Long, Esq.  
T.U.R.N.  
625 Polk Street, Suite 403  
San Francisco, CA 94102

ALJ GLEN WALKER \*Rn. 5111

Rufus G. Thayer \*Rn. 5123

William Thompson \*Rn. 4012