Decision 83 04 012 APR 6 1983

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.	Application 59849 (Filed August 1, 1980; amended August 28, 1980 and October 14, 1980)
In the Matter of the Application of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California.	Application 59269 (Filed November 13, 1979; amended November 15, 1979)
Re Advice Letter (PT&T) No. 13640 to reprice certain telephone terminal equipment and Resolution No. T-10292 granting approval of said changes.	Application 59858 (Filed August 1, 1980)
In the Matter of Advice Letter Filing No. 13641 of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY for authority to increase certain rates for key telephone service by $30.1 million.	Application 59888 (Filed August 19, 1980)

Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, costs, separations, inter-company settlements, contracts, service, and facilities of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a California corporation; and of all the telephone corporations listed in Appendix A, attached hereto.	OII 63 (Filed December 18, 1979)
Investigation on the Commission's own motion into the rates, tolls, rules, charges, operations, costs, separations, inter-company settlements, contracts, service, and facilities of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY, a California corporation; and of all the telephone corporations listed in Appendix A, attached hereto.	OII 81 (Filed August 19, 1980)
Investigation on the Commission's own motion into the Matter of Revision of the Accounting for Station Connections and related Ratemaking Effects and the Economic Consequences of Customer-owned Premise Wiring.	OII 84 (Filed December 2, 1980)

OPINION ON REVISED COSTING PROCEDURES

In Decision (D.) 93367 issued August 4, 1981 in these proceedings, the Commission found there were substantial weaknesses in the costing methods used by The Pacific Telephone and Telegraph Company (Pacific) to support its rate design proposals. Consequently, the Commission ordered further hearings to review and determine equitable costing procedures. Those hearings have been held. At their conclusion, because of the complexities of the issues involved, the parties participating in this phase of the proceeding agreed to a special, seven-step procedure for bringing the issues to the Commission for decision. Under that procedure, (1) each party presented the assigned administrative law judge (ALJ) with a list of major issues, (2) the ALJ combined them into a single list, (3) the parties briefed their positions on those issues, (4) by a ruling, the ALJ gave his position on the issues and how they should be addressed in the cost studies, (5) the parties then held a series of meetings under the aegis of the Commission staff (staff) to develop as near as possible a consensus on the procedures to be adopted, (6) the staff gave the recommended procedures to the ALJ who reviewed them and made his final recommendation to the Commission November 10, 1982, and, (7) the parties filed exceptions to the ALJ proposal on December 13, 1982. Exceptions to the ALJ proposal were filed by Pacific, staff, Telephone Answering Services of California (TASC), General Telephone Company of California (General), Western Burglar and Fire Alarm Association (WBFA), and, collectively, The American Broadcasting Companies, Inc., CBS Inc., the California Retailers Association, and the Tele-Communications Association (Users Group). Our discussion will generally follow the subject matter in the form and sequence presented by the ALJ with the exception of some general comments offered by Pacific.

Pacific's General Comments

Pacific expresses great concern that if the Commission were to adopt the cost procedures recommended by the ALJ, the Commission would not be able to determine whether the revenues generated by a particular product line or service would be sufficient to cover the costs associated with such product line or service. Any deficiency in revenues for a given product line or service must be provided by another product line or service or by the residual ratepayers. Pacific claims that adoption of the ALJ recommendation will result in costs that do not match back to book totals, particularly in the area of investment and depreciation. This is because the method proposed by the ALJ for development of the depreciated investment factor understates Pacific's net book investment for particular product lines and services. Indeed, Pacific is correct, but the ALJ's proposal faces up to a problem that has plagued the entire scheme of cost development and rate setting procedures used in past proceedings. That problem is what appears to be a rather substantial amount of stranded investment[1] in Pacific's books of account, an undepreciated investment that will continue on the books and, unless something is done to change depreciation practices, just get larger and larger. If the adoption of the ALJ's recommendations will bring that stranded investment into focus, then so be it, and the sooner the better.

This record is replete with examples of how and why the stranded investment got there: in the main, it is probably because we have failed to write off equipment at proper depreciation rates; some of it may be due to the so-called migration strategy. Because of the accounting methods we use, equipment retired before we expected it would be retired leaves part of its investment to be picked up by depreciation on other equipment still in service. In Exhibit 480, Users Group witness Selwyn gave a simple but telling example of how

[1] Pacific prefers to call it a reserve deficiency.

stranded investment can come about under the accounting procedures used by Pacific and approved by the Commission. From pages 6 through 8 of Exhibit 480 the following questions and answers are quoted:

> "Q. Dr. Selwyn, a major area of concern throughout this proceeding has been the appropriate level of net investment - the so-called 'Net Plant Factor' - to use for determining the cost of individual services. Pacific asserts that the NPF should be based upon the embedded condition of the Company's plant accounts by product group, whereas you argue for an approach which seeks to recognize capital recovery payments already made by existing customers as offsets to the original investment cost of the equipment or facility. Does the distinction you have made between 'revenue requirements' and 'economic' studies enter into this issue?
>
> "A. Yes, most definitely. Once again, Pacific's approach concerns itself only with a single accounting period - what has occurred in the past, or what will occur in the future, is of no consequence whatsoever under this view. Suppose that in 1977 Pacific provided identical service to two customers, A and B - and let us assume that these are the only customers Pacific serves. At the time, the telephone company invested $10,000 in equipment for each of the two customers, with an expected average service life for each unit of 5 years. Under the GE100 cost methodology which Pacific would have used in setting the rates for the service, each customer would have paid, as part of the recurring rate, an annual depreciation charge of $2,000 [$10,000/5]. Suppose that, at the end of the third year, customer A decided to discontinue his service, and that the equipment would not be reused once removed from service. By the end of the third year,

$12,000 of the original $20,000 total investment had been depreciated, such that a net investment of $8,000 remained for the two units. However, when the unit removed from customer A is retired, the gross investment is reduced to $10,000, and the depreciation reserve is reduced to $2,000. Under the revenue requirements theory, customer B would be confronted with a Net Plant Factor of 80%, and would be required to pay for return and associated income taxes on the basis of an $8,000 remaining net investment out of the original $10,000 for the equipment actually furnished to him, despite the fact that he had previously made $6,000 of capital recovery payments. Suppose further that, in 1980, Pacific asked for the adoption of a Straight Line Remaining Life (SLRL) depreciation method with a 2-year remaining life, and, pursuant to the revenue requirements approach to individual service cost studies, applied SLRL in its GE100 study for this service. The remaining $8,000 of net investment would now have to be recovered in 2 years, with annual depreciation charges of $4,000. If customer B retains the service for the full two years, he will have paid a total of $14,000 in capital recovery charges ($2,000 per year for the first three years, and $4,000 per year for the last two years), whereas customer A will have paid only $6,000 in capital recovery for his service. Pacific's revenue requirement approach thus forces the remaining customer (customer B in this example) to subsidize the loss of capital recovery caused by the early departure of customer A.

"Q. What happens if customer B, faced with large rate increase, decides to discontinue his service immediately?

"A. In that situation, Pacific will be left with $8,000 of undepreciated investment which, again pursuant to its revenue requirements approach, will have to be paid by other customers - in this instance, customers of other services. If, on the other hand, customer B were not subjected to a rate increase as a consequence of customer A's departure and, as a result, retained his service for the two remaining years, Pacific would have recovered a total of $16,000 ($6,000 from customer A and $10,000 from customer B) leaving only $4,000 (instead of $8,000) to be recovered from other customers. The cost causer here was clearly customer A or whatever instigated his decision to discontinue the service, yet Pacific's cost methodology seeks to recover those costs from customer B, and, if he balks (by leaving), from customers of other services."

Pacific recommends what it calls a "prospective deaveraged" depreciation investment factor. This is a different approach than the one it proposed in the original GE-100 costing procedures for this case; instead of using one depreciated investment factor for all equipment cost studies, different factors would be used for different product groups. But those factors are still brought back to book totals, thereby continuing a pick up of the stranded investment on the company's books. On the other hand, if we adopt the ALJ's recommendation, some estimate of the size of the stranded investment should become available.

Users Group and others claim that part of the stranded investment problem is due to Pacific's migration strategy policy, an issue we thoroughly discussed in D.93367. Users Group would like to

see the ALJ procedure adopted and any stranded investment picked up by the stockholders of Pacific, which at this time is the single entity, American Telephone and Telegraph Company (AT&T). Pacific has two proposals before us for adjusting depreciation expense totaling about $235 million per year. Granting of those requests could relieve some of the stranded investment pressure. However, any changes in equipment depreciation practices must be considered in the context of the two important matters currently affecting the federal and state regulation of AT&T and Pacific; these are the Federal Communications Commission (FCC) decisions concerning the Computer II inquiry (CI-II) and the modified final judgment in the antitrust case now being concluded in federal court by Judge Harold H.Greene. We believe the decision we will issue here on proper costing procedures should be done independently of the problems mentioned above with those problems addressed in later decisions on the issues of adjusting depreciation allowances.

Finally, the costing methods adopted do not mean that any rates proposed must bear a fixed relationship to costs. Pacific can propose anything it wants in the way of rates which would bring the revenues derived from such rates to the overall revenue requirement found reasonable by the Commission.

The second general criticism of the proposed procedures by Pacific is that there should be no references in the manuals to pricing. Pacific's point is well taken in that a costing manual should not <u>mandate</u> pricing plans or structures. We will make the appropriate adjustments to the ALJ's recommendations; however, we do want the manual to indicate from a policy standpoint the kinds of pricing plans and structures the Commission will want developed from costing procedures. Whether a utility sees fit to make such pricing plans available on its own is up to it; to the extent the cost manuals appear to require the offering of specific pricing plans they will be adjusted.

The ALJ recommends two separate cost procedures, one for terminal equipment service and one for private line service. In the following discussion we will be addressing both manuals section-by-section unless otherwise indicated.

I - General

Pacific recommends that paragraph 1 be deleted because references to pricing policy should not be contained in a cost manual. Pacific recommends paragraph 4 be deleted because the manuals should be generic and applicable to the future; references to current issues such as Pacific's divestiture plans are not appropriate. To clarify the purpose and objective of the manuals and the costing process, Pacific recommends its suggestions be adopted and a paragraph added to the general sections to state that:

> It is the purpose of this manual to develop a revenue requirement for the utility's individual products and services in a manner that is consistent with how the Commission calculates such utility's overall revenue requirement for ratemaking purposes. Such individual revenue requirements are to be used as benchmarks in assessing the reasonableness of the rates associated therewith, but are not intended to be used as a mechanical formula for setting such rates.

We will modify paragraph 1 to reflect our previous discussion under Pacific's general comments. We agree that paragraph 4 should be deleted but expect those who use the manual to make appropriate allowances for matters such as that cited. We will reject Pacific's proposed paragraph for the reasons stated under our discussion of Pacific's general comments. However, the suggested statement concerning mechanical formulas and rate setting will be incorporated.

Staff recommends that Paragraph 3 be rewritten so that costs of existing terminal equipment offerings would be developed on an individual tariff offering basis to the extent feasible. The ALJ

recommends an option of costs developed on a product group basis to reflect costs of typical systems or on an individual tariff offering basis. We prefer the flexibility of the ALJ's approach and note that both Pacific and staff witnesses made that recommendation.

Staff questions how ratemaking adjustments will be presented or incorporated in the utility's service cost studies. General requests a further explanation of the types of ratemaking adjustments covered by Paragraph 6 with examples of how and when they should apply. As the staff points out, it should be understood that proposed ratemaking adjustments by the parties must be assigned or allocated in an appropriate manner by the party proposing the change. If the parties cannot reasonably make the required modifications then they should petition the presiding officer to order the utility or some other appropriate party to make the changes so the Commission may assess the effects of the proposals. Utilities will be expected to make a reasonable effort to reflect those ratemaking adjustments adopted by the Commission in previous proceedings with the expectation that they would be made in any future proceedings, e.g. Western Electric adjustments.

Staff recommends a statement in I - General that detailed documentation shall be made available by the utility which describes all procedures and separation processes, input data sources, and all reports used in the preparation of such cost studies. Although it is usually understood such information should be made available to parties, no harm will be done by including the requirement in the adopted procedures.

General opposes Paragraph 5 on the grounds that existing accounting procedures do not allow direct reconciliation to historical costs or test-year estimated results of operations. General misunderstands Paragraph 5; no forced reconciliation is expected. But if there is not a reconciliation, then some

explanation of the differences should be provided. In contrast, Pacific argues strongly that total costs including a return and tax factor should balance out to the revenue requirement found reasonable for the utility; that is, we presume, "test-year estimated results of operations."

WBFA urges that Paragraph 5 require a "bottom up" versus "top down" reconciliation between the product line and the category studies. We believe the ALJ recommended language makes it imperative that some sort of reconciliation, perhaps not the one recommended by WBFA, be accomplished. We prefer to leave the exact manner of how that is accomplished to the parties presenting the cost studies, rate designs, and requested revenue requirement. WBFA recommends that Paragraph 7, the cost study format, should reflect that private line service costs are the sum of the annual costs of a number of components consisting of different investment categories. It suggests that the best way to recognize this is to present the cost study format in multicolumnar form with a total column at the far right. We agree with WBFA but note there is no need to incorporate this into the suggested format which, by its nature, has that flexibility.

Users Group recommends the manuals put more emphasis on cost development that reflects a vintaged or fixed-term contract approach to pricing. Users Group believes contract pricing ensures the utility will recover the capital costs associated with the provision of a new service from the customer to whom the service is provided. Pacific, as noted earlier, believes a cost manual is no place to indicate pricing plans and structures. We will modify Paragraph 1 so that it reflects Commission policy on the types of cost studies the Commission wants so that pricing can be developed which will bring into the open some of the depreciation problems we discussed previously with a view toward recommendations from the parties on how to alleviate those problems.

II - Investment

Pacific claims Paragraphs 1 and 2 appear to require Pacific to develop two sets of costs for existing products and services with inward movement. We interpret the paragraphs as requiring investment costs for equipment already in service and separate costs for equipment that will be inward moving during the study period. We agree with Pacific that the reference to CI-II in Paragraph 2 should be deleted. We will also adopt Pacific's recommendations for changes in Attachment 2, Paragraphs 4.b., and 7. to the Private Line Service cost manual.

WBFA believes there is one accounting complexity which the manual should address because it offers an opportunity for utilities to double charge users. This has to do with station connection costs which have now been split into a writeoff over ten years for connections in place prior to 1981 and expensing of connections installed after 1980. WBFA wants to make sure that costs for inside wiring be treated as either investment or expense but not as both. WBFA suggests a paragraph be added to the procedures to ensure this. We believe there is no need for such detail in a costing manual. The paragraph that we will add to I - General at the suggestion of the staff covering documentation and data sources should protect against the problem suggested by WBFA.

III - Depreciated Investment

Pacific again states in its argument that the methods recommended by the ALJ will not develop a depreciated investment for the individual products or services that is consistent with the FCC or Commission prescribed depreciation accounting or which is consistent with how the Commission develops depreciated investment for the overall revenue requirement for ratemaking purposes. Again we recognize this but if we do not adopt the ALJ recommendation, we will have accomplished almost nothing in the area of depreciated

investment factors and would be right back where we started prior to the further hearings on these procedures. We will adopt Pacific's suggested additional paragraph concerning how estimates of total life and remaining life should be made. That would be subject of course to review by the staff and other parties.

General requests some guidelines on how book value might be determined for those units removed from service since the book value of retired units will affect the net investment in surviving units. We suggest that estimates of total life used for depreciation purposes be matched against the age of equipment at retirement for that purpose.

WBFA recommends specific wording on how the depreciation of drop wire investment should be calculated. Again, we believe this kind of detail should be left to the user of the guidelines and not included in a manual.

IV - Rate of Return and Income Taxes

Pacific recommends the return component of the cost study be developed using the account or subaccount net plant factors rather than either of the depreciated investment factors recommended in the manuals. Again Pacific cites the potential for a revenue requirement deficiency as its reason for the recommendation. Again we reject the suggestion for the reasons stated above.

General recommends that the rate of return for different services should vary directly with the risk associated with the service provided. Adoption of this suggestion would return us to the old method of different rates of return for different vintages or types of cost studies and is firmly rejected. All customers should pay the same for the support of the investment needed to provide the equipment to service them with the understanding of residual pricing as a policy. All customers pay a certain portion of the residual revenues necessary to make the utility whole. For example, all customers pay some toll charges at some time, though some pay more, some less.

V - Depreciation

Pacific again urges accounting depreciation be used. Again, for the reasons noted at several places above, we reject the recommendation.

VI - Operating Expenses

TASC, WBFA, and Users Group all express concern about testing costs and cost factors for reasonableness. TASC believes the provision that a panel of estimators, most likely from the utility, should develop work times and other cost factors with a review by the Commission staff would provide no improvement over the studies originally submitted in this proceeding and found wanting by the Commission. TASC claims the record demonstrates that no meaningful staff review of Pacific's estimates has been or is likely to be undertaken. TASC submits that Pacific should be required to document the costs it claims to have incurred in the provision of maintenance and installation services and, when its costs are challenged, submit evidence through competent witnesses, tracking mechanisms, and record-keeping systems which will provide appropriate proof of costs and the opportunity for meaningful review.

WBFA recommends two modificiations to § VI. Paragraph 4 would be reworked to emphasize both recurring and nonrecurring work activity validations and a new paragraph would be added to ensure clear delineation of recurring and nonrecurring work activities so there could be no double counting of expenses.

Users Group offers two suggestions which it believes would help assure the work times Pacific uses in the development of nonrecurring work costs are reasonable and reflect only efficient operations. The first would be a rewording of the ALJ's Paragraph 4 to require staff review of Pacific's estimates under certain conditions. The second is recommended only if the Commission does not adopt the first, and would provide for independent panels of experts paid by the ratepayers if they verify Pacific's estimates or by Pacific's stockholders if they do not.

We will adopt some rewording of the section that is a combination of the recommendations of TASC, WBFA, and Users Group which we believe will provide the protections the parties seek and yet not put too great a burden on Pacific or the staff, although it will require a much more active role for the staff in the first one or two applications of the costing procedures.

IX - Installation Charge Credit

Both Pacific and staff attack the proposed method of developing the installation charge credit. They claim the method recommended by the ALJ will overstate the value of the installation revenues received during the year of installation and thus understate adjusted annual costs. Staff states further that treatment in the cost study should be consistent with the actual accounting treatment of nonrecurring costs and investments made in connection with establishment of service. Staff views the installation charges as an advance payment of charges that would otherwise be recovered over the location life of the installation. It recommends installation charges be converted to a series of payments over the location life using capital recovery factors to provide uniform annual payments. The method adopted by the ALJ is a return to the method used prior to 1978 and recommended by Users Group. This method may be termed the return and depreciation credit method. By this method the installation charge is assumed to be an advance payment of capital costs which will be incurred over the location life of the installation. Credits to the annual charges are made for return and taxes and depreciation of the nonrecoverable, up-and-down costs to the extent they are recovered by the installation charge. The staff's principal objection to the method is that it requires a complex, three-factor calculation. The staff gave an example of the two types of calculations in its brief and the resulting monthly charge is almost identical under the two methods. We will adopt the ALJ's recommendation because it appears to be more consistent with the development of other estimated annual charges.

Application of the Adopted Procedures

Users Group recommends that, at the very least, Pacific should be required to make revised cost studies based on the procedures adopted in this decision for those services it proposed to increase in A.59849. We note that the interim rate increase granted by D.93367 held rate increases to a minimum for equipment and services subject to the questionable cost study procedures of Pacific. We further note that Pacific now has before us another major rate case. We believe it would be reasonable to allow Pacific to make the decision on whether it wants to redo A.59849 studies or make new studies and present them in the current rate case with any necessary rate adjustments being made in the decision on the current case.

One consideration, which in fairness to Pacific it might like to know in assessing its options, is that in D.93367 we adopted the principle of a maximum 50 percent increase in any one application for those services or equipment requiring a greater than 50 percent increase; we would amend that to 100 percent should Pacific choose to adopt the new costing procedures in the current application and forego any recalculation of the A.59849 studies.

Several parties commented on the hard work that has gone into revising the procedures; we join in those comments commending all the participants for their efforts. We hope the parties will give the procedures a fair try. We will be the first to acknowledge they will not be found perfect and may have to be amended as experience is gained in their application.

Findings of Facts

1. In D.93367 the Commission found there were substantial weaknesses in the costing methods used by Pacific to support its rate design proposals and ordered further hearings to determine equitable methods for developing cost of service studies for ratemaking.

2. The hearings ordered by the Commission have been held and all interested parties had a chance to appear and be heard.

3. The assigned ALJ made a proposal to the Commission on the procedures he recommends be adopted, and the parties have filed their exceptions to the ALJ's proposal.

4. The costing procedures attached as Attachments A and B are the procedures recommended by the ALJ, amended as discussed in the body of this opinion as a result of Commission review of the record and comments of the parties. These costing procedures are reasonable for the purpose of developing cost of service studies for telephone utilities under the jurisdiction of the Commission.

5. It is reasonable to give utilities subject to these proceedings the option of applying the new procedures to recalculate costs in these proceedings or use them for the first time in their next major rate case.

6. Because there is a need for the expeditious application of the procedures adopted, this decision should be effective on the date signed.

Conclusion of Law

Based on the foregoing findings of fact and under Public Utilities Code § 454(b) the Commission may require telephone utilities to use the costing procedures adopted by the following order as part of the showing required to be made in support of rates for the provision of telephone services and equipment.

O R D E R

IT IS ORDERED that:

1. Telephone utilities subject to this Commission shall use the costing procedures contained in Attachments A and B in support of rates for the provision of telephone services and equipment under the jurisdiction of this Commission.

2. The first application of the costing procedures adopted by this decision may be made in any ongoing major rate case of the utilities or in the next major rate case NOI of the utilities tendered after June 30, 1983.

This order is effective today.

Dated April 6, 1983, at San Francisco, California.

LEONARD M. GRIMES, JR.
President
VICTOR CALVO
PRISCILLA C. GREW
DONALD VIAL
Commissioners

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

Joseph E. Bodovitz, Executive Director

ATTACHMENT A
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PROCEDURES FOR DEVELOPMENT OF TERMINAL EQUIPMENT SERVICE COSTS

PROCEDURES FOR DEVELOPMENT OF TERMINAL EQUIPMENT SERVICE COSTS

I - GENERAL

1. In the development of costs for proposed rates and charges for new or existing service offerings consideration should be given to the rate treatment to be applied. Among the rate structures the Commission would like considered whenever feasible is the provision of service on a "vintaged" or fixed term contract basis in addition to traditional month-to-month service. A special charge for early termination could be included in fixed term contract offerings, and a choice of contract period (e.g. 3, 5, 7, and 10 years) should be made available when appropriate. Cost studies should be formulated so they support the proposed tariff structure. For example, if services are to be offered under a contractual type tariff arrangement such as "Variable Term" (Decision 82-03-058) or "Two Tier" (Decision 83958) payment plans, cost studies should reflect vintage investment costs.

2. In general all cost inputs should be service specific where appropriate and should reflect a "prospective" two-year study period. Cost inputs associated with vintaged, fixed term contract type studies should reflect estimated operating expenses during the contract period.

3. Costs of existing terminal equipment offerings may be developed on a product group basis to reflect costs of typical systems or on an individual tariff offering basis.

4. Wherever possible cost estimates should reconcile to historical costs or to test year estimated results of operations; where they do not, an explanation should be provided (e.g. see "Depreciated Investment" below). Revenue requirements may be used as benchmarks in assessing the reasonableness of rates associated with costs developed by these procedures but are not intended to be used in a mechanical formula for setting rates.

5. Ratemaking adjustments should be assigned or allocated to cost studies where appropriate.

6. Cost study format should generally follow that shown in Appendix A.

7. So that interested parties may effectively analyze and audit cost studies presented by the utilities, detailed documentation shall be made available for review which includes algorithms describing all procedures and separation processes, workpapers, input data sources, and reports used to prepare the cost studies.

II - INVESTMENT

1. For equipment and services provided to existing customers investment should reflect average original cost (AOC) during the study period plus appropriate loadings.

2. For services provided to inward moving customers or as additions to existing systems (prospective placements) investment should reflect a melding of new and reused equipment costs during the study period.

3. For vintage pricing cost studies, the investment amount, either AOC or weighted average investment during the study period, once set, will not be changed for future cost analyses of that vintage.

4. In nonvintage pricing cost studies the investment will reflect the AOC of units provided on a companion basis or all units provided on a month-to-month basis, whichever is applicable.

III - DEPRECIATED INVESTMENT

1. Where feasible, the level of depreciated investment used for terminal equipment cost studies will be determined by a "depreciated investment factor" (DIF) calculated on the basis of one of the following methods:

   a. Scale to position in life; or
   b. Net investment in surviving units.

2. Different types of investment may have different DIFs, thus factors should be developed for each investment account and subaccount represented in the cost study.

3. DIFs may require recalculation for each new planning period.

4. The total life and remaining life values shall be based on estimates made by the utility's marketing and engineering personnel.

IV - RATE OF RETURN AND INCOME TAXES

1. Rate of return and income taxes (RIT) should reflect the authorized or requested rate of return as appropriate and applicable income tax laws.

2. The same rate of return should be used for all cost studies.

3. The development of the RIT factor is shown in Appendix B.

V - DEPRECIATION

1. The depreciable portion of an investment is the original cost less the net salvage value (NSV) of the asset when it is removed from service for the last time. NSV represents the gross salvage value at the time of removal less the costs associated with the removal. An estimate of NSV must be made prior to the development of the depreciation rate because only the original cost less net salvage may be recovered through depreciation charges.

2. NSV should reflect the value received at the time of retirement if sold as:

   a. Operable telecommunications equipment; or
   b. Component parts for use in maintenance, expansion or other purposes for equipment of like variety which is still in active use; or
   c. Scrap;

whichever is greatest. Cost of removal should reflect estimated location cycles where applicable and actual method of removal. The following information to support estimates of salvage value should be provided:

   a. Estimated future gross salvage value;
   b. Nature of disposition assumed in a., i.e. intact, in parts, or as scrap;

c. Source of the estimate (e.g. arm's length sale; qualified independent appraiser; imputed from experience in other used equipment markets);
d. Explanation of the basis for believing the estimate is highest possible value, including qualifications of sources relied upon;
e. Estimated costs of removal and the basis for the estimate.

3. For fixed term contract pricing cost studies the remaining life (RL) depreciation rate will not be changed once established for that study period.

4. For nonfixed term contract (month-to-month) pricing cost studies, the RL depreciation rate may be changed to reflect changes in estimated RL.

5. RL for depreciation purposes will be developed on a basis consistent with the development of the DIF in Section III above.

6. Depreciation expense will be calculated as follows:

Depreciation expense = [(AOC x DIF) - NSV] ÷ RL

where AOC = average original cost (loaded)

DIF = depreciated investment factor

NSV = net salvage value

RL = remaining life

VI - OPERATING EXPENSES

1. Operating expenses include maintenance and commercial expenses and other charges and taxes.

2. Operating expense should be service (product) specific to the extent feasible. Expenses may be directly estimated or based on ratios (e.g. maintenance to plant) where service (product) specific studies are not feasible.

3. Costs and benefits or service improvement programs should be allocated or assigned on a consistent basis to the specific services to which the improvement programs apply.

4. Operating expenses associated with recurring and nonrecurring work activities should reconcile to historical totals and should be validated for reasonableness and operating efficiencies. The manner in which inputs are tested for reasonableness and efficiency will be by a panel of estimators subject to Commission staff review. Staff will make its review only when nonrecurring costs increase on a percentage basis greater than utility usage rates, or when evidence is presented which shows that nonrecurring cost studies may not have properly accounted for improved efficiencies.

5. Recurring and nonrecurring work activities should be clearly delineated so there are no omissions or double counting of operating expenses.

VII - GENERAL ADMINISTRATION EXPENSES

1. Administration expenses directly related to a service group/product line should be developed on a service/product specific basis.

2. Administration expenses which reflect joint costs or common corporate overheads should be allocated to service groups/product lines on an appropriate basis (e.g. on the basis of investment or other direct costs).

VIII - RATEMAKING ADJUSTMENTS

1. Known ratemaking adjustments (see Section I above) developed by the utility for the purpose of indicating results of operations on a ratemaking basis ("post column 'a' adjustments") should be reflected in the cost studies submitted with supporting work papers when the results of operations are tendered for consideration.

2. Ratemaking adjustments proposed by interested parties or the CPUC staff should be assigned or allocated to cost studies in an appropriate manner by the party proposing the adjustment. If parties choose to revise the service cost studies

submitted by the utility in lieu of recalculating cost elements proposed by the utility, the adjustments should reconcile the service cost studies to the level of expenses and rate base included in that party's showing of results of operations.

IX - INSTALLATION CHARGE CREDIT

1. A credit to annual charges to reflect payment of an installation charge will be included in all cost studies for terminal equipment offerings which anticipate inward movement.

2. The adjustment to annual charges will be calculated as shown in Appendix C.

APPENDIX A

COMPUTATION OF SERVICE COSTS

Investment

1. Average Original Cost (loaded) $_____

2. Depreciated Investment Factor _____%

3. Net Depreciated Investment (Ln 1 x Ln 2) $_____

Annual Charges

4. Rate of Return and Income Taxes (RIT x Ln 3) $_____

5. Depreciation (Ln 1 x ____%) $_____

6. Maintenance $_____

7. Commercial/Marketing $_____

8. Other taxes/other charges $_____

9a. General Administration Expenses: Direct $_____

9b. : Allocated $_____

10. Rate Making Adjustment $_____

11. TOTAL ANNUAL COSTS (Lns 4 through 10) $_____

12. Installation Charge Credit $_____

13. Adjusted Annual Costs (Ln 11 - Ln 12) $_____

APPENDIX B

RATE OF RETURN AND INCOME TAX FACTOR

$$RIT = \frac{R - IC - I(t_1 + t_2 - t_1t_2) - D(t_1 - t_1t_2)}{(1. - t_1 - t_2 + t_1t_2)\ (1. - \text{Depreciation Reserve})}$$

or

$$RIT = (R + T_1 + T_2) \div (1. - \text{Depreciation Reserve})$$

Where:

R = return [COM x (1 - Depreciation Reserve - Deferred Tax Reserve)]

T_1 = state taxes

T_2 = federal taxes

COM = cost of money (authorized or requested rate of return)

t_1 = state tax rate

t_2 = federal tax rate

I = interest [interest rate x debt ratio x(1-Depreciation Reserve-Deferred Tax Reserve)]

IC = investment tax credit (e.g. 10% ÷ product life)

D = difference between accelerated and straight line depreciation

Example: Rate of Return = 12%

COM = .12	Interest Rate = .08
IC = .00667	Debt Ratio = .45
D = .02523	Deferred Tax Reserve = .0906
t_1 = .105	Depreciation Reserve = .130
t_2 = .46	

Calculations

R = .12 x (1. - .130 - .0906) = .0935

I = .08 x .45 x (1. - .130 - .0906) = .0281

$t_1 + t_2 - t_1t_2$ = .105 + .46 - .105 x .46 = .5167

$t_1 - t_1t_2$ = .105 - .105 x .46 = .0567.

$1. - t_1 - t_2 + t_1t_2$ = 1. - .105 - .46 + .105 x .46 = .4833

$$RIT = \frac{.0935 - .00667 - .0281 \times .5167 - .02523 \times .0567}{.4833 \times (1. - .130)}$$

RIT = .1686

APPENDIX C

INSTALLATION CHARGE CREDIT

Line 12, Appendix A, Installation Charge Credit will be calculated as follows:

$$ICC = CRIT + CD - ITL$$

where ICC = Installation charge credit
CRIT = Credit for return and taxes
CD = Credit for depreciation
ITL = Income tax loss

When an installation charge is applied, the total annual costs (line 11 of Appendix A) shall be credited by the cost of money and income tax (return and tax factor) effects associated with the installation charge. The credit is calculated by multiplying the return and tax factor (line 4, Appendix A) by the amount of the installation charge. A credit for depreciation expense shall also be calculated consistent with the depreciation expense determined in line 5 of Appendix A.

In addition when an installation charge is made, the amount is usually credited to the revenue accounts. This results, in the first year, in revenues exceeding expense and Federal and State income taxes are applicable to the difference. In succeeding years, the reverse is true and expense will exceed revenue, resulting in income tax credits which will result in complete recovery of the first year's excess tax payment by the end of the Location Life. There is, however, a loss of earning power on the unrecovered portion of the tax during this interim period (second through last years). These amounts converted into present worth and then into an equivalent annuity must be added to the annual costs.

(END OF ATTACHMENT A)

PROCEDURES FOR DEVELOPMENT OF PRIVATE LINE SERVICE COSTS

PROCEDURES FOR DEVELOPMENT OF
PRIVATE LINE SERVICE COSTS

I - GENERAL

1. In the development of costs for proposed rates and charges for new or existing service offerings, consideration should be given to the rate treatment to be applied. Among the rate structures the Commission would like considered, whenever feasible, is the provision of service on a "vintaged" or fixed-term contract basis in addition to traditional month-to-month service. A special charge for early termination could be included in fixed-term contract offerings, and a choice of contract period (e.g. 3, 5, 7, and 10 years) should be made available when appropriate. Cost studies should be formulated so they support the proposed tariff structure. For example, if services are to be offered under a contractual type tariff arrangement such as "Variable Term" (Decision 82-03-058) or "Two Tier" (Decision 83958) payment plans, cost studies should reflect vintage investment costs.

2. In general all cost inputs should be service specific where appropriate and should reflect a "prospective" two-year study period. Cost inputs associated with vintaged fixed-term contract type studies should reflect estimated operating expenses during the contract period.

3. Cost studies for existing private line offerings should be developed on a service group/product line basis. (Service groups/product lines to be studied by Pacific are indicated in Attachment 1.)

4. Wherever possible cost estimates should reconcile to historical costs or to test year estimated results of operations; where they do not, an explanation should be provided (e.g. see "Depreciated Investment" below). Revenue requirements may be used as benchmarks in assessing the reasonableness of rates associated with costs developed by these procedures but are not intended to be used in a mechanical formula for setting rates.

5. Ratemaking adjustments should be assigned or allocated to cost studies where appropriate.

6. Cost study format should generally follow that shown in Appendix A.

7. So that interested parties may effectively analyze and audit cost studies presented by the utilities, detailed documentation shall be made available for review which includes algorithms describing all procedures and separation processes, work papers, input data sources, and reports used to prepare the cost studies.

II - INVESTMENT

1. Investment should reflect average original cost (AOC) during the study period plus appropriate loadings for each basic cost element for each service group/product line studied. Cost elements to be studied are indicated in Attachment 2.

2. For fixed-term contract pricing cost studies, the investment amount will not be changed once it has been established for that study period.

III - DEPRECIATED INVESTMENT

1. Where feasible, the level of depreciated investment associated with each private line cost element will be determined by a "depreciated investment factor" (DIF) calculated on the basis of one of the following methods:

   a. Scale to position in life; or

   b. Net investment in surviving units.

2. Different types of investment may have different DIFs, thus factors should be developed for each investment account and subaccount represented in the cost study. Specific DIFs should be developed on a disaggregated basis for each major generic and homogeneous subcategory of plant within the central office circuit equipment investment subaccount (e.g. for appropriate cost elements shown in Attachment 2), and main frame costs should be disaggregated from switching costs for the purpose of developing DIFs.

3. DIFs may require recalculation for each new planning period.

4. The total life and remaining life values shall be based on estimates made by the utility's marketing and engineering personnel.

IV - RATE OF RETURN AND INCOME TAXES

1. Rate of return and income taxes (RIT) should reflect authorized or requested rate of return as appropriate and applicable income tax laws.

2. The same rate of return should be used for all cost studies.

3. The development of the RIT factor is shown in Appendix B.

V - DEPRECIATION

1. The depreciable portion of an investment is the original cost less the net salvage value (NSV) of the asset when it is removed from service for the last time. NSV represents the gross salvage value at the time of removal less the costs associated with the removal. An estimate of NSV must be made prior to the development of the depreciation rate because only the original cost less net salvage may be recovered through depreciation charges.

2. NSV should reflect the value received at the time of retirement if sold as:

   a. Operable telecommunications equipment; or

   b. Component parts for use in maintenance, expansion, or other purposes for equipment of like variety which is still in active use; or

   c. Scrap;

whichever is greatest. Cost of removal should reflect estimated location cycles where applicable and actual method of removal. The following information to support estimates of salvage value should be provided:

   a. Estimated future gross salvage value.

   b. Nature of disposition assumed in a., i.e. intact, in parts, or as scrap.

   c. Source of the estimate (e.g. arm's length sale; qualified independent appraiser; imputed from experience in other used equipment markets).

d. Explanation of the basis for believing the estimate is highest possible value, including qualifications of sources relied upon.

e. Estimated costs of removal and the basis for the estimate.

3. For fixed-term contract pricing cost studies the remaining life (RL) depreciation rate will not be changed once established for that study period.

4. For nonfixed-term contract (month-to-month) pricing cost studies, the RL depreciation rate may be changed to reflect changes in estimated RL.

5. RL for depreciation purposes will be developed on a basis consistent with the development of the DIF in Section III above.

6. Depreciation expense will be calculated as follows:

Depreciation expense = [(AOC x DIF) - NSV] ÷ RL

where AOC = average original cost (loaded)

DIF = depreciated investment factor

NSV = net salvage value

RL = remaining life

VI - OPERATING EXPENSES

1. Operating expenses include maintenance and commercial expenses and other charges and taxes.

2. Operating expenses should be service (product) specific to the extent feasible. Expenses may be directly estimated or based on ratios (e.g. maintenance to plant) where service (product) specific studies are not feasible.

3. Costs and benefits or service improvement programs should be allocated or assigned on a consistent basis to the specific services to which the improvement programs apply.

4. Operating expenses associated with recurring and nonrecurring work activities should reconcile to historical totals and should be validated for reasonableness and operating efficiencies. The manner in which inputs are tested for reasonableness and efficiency will be by a panel of estimators subject to Commission staff review. Staff will make its review only when nonrecurring costs increase on a percentage basis greater than utility usage rates, or when evidence is presented which shows that nonrecurring cost studies may not have properly accounted for improved efficiencies.

5. Recurring and nonrecurring work activities should be clearly delineated so there are no omissions or double-counting of operating expenses.

VII - GENERAL ADMINISTRATION EXPENSES

1. Administration expenses directly related to a service group/product line should be developed on a service/product specific basis.

2. Administration expenses which reflect joint costs or common corporate overheads should be allocated to service groups/product lines on an appropriate basis (e.g. on the basis of investment or other direct costs.)

VIII - RATEMAKING ADJUSTMENTS

1. Known ratemaking adjustments (see Section I above) developed by the utility for the purpose of indicating results of operations on a ratemaking basis ("post column 'a' adjustments") should be reflected in the cost studies submitted with supporting work papers when the results of operations are tendered for consideration.

2. Ratemaking adjustments proposed by interested parties or the CPUC staff should be assigned or allocated to cost studies in an appropriate manner by the party proposing the adjustment. If parties choose to revise the service cost studies submitted by the utility in lieu of recalculating cost elements proposed by the utility, the adjustments should reconcile the service cost studies to the level of expenses and rate base included in that party's showing of results of operations.

APPENDIX A

COMPUTATION OF SERVICE COSTS

Investment

1. Average Original Cost (loaded) $_____

2. Depreciated Investment Factor _____%

3. Net Depreciated Investment (Ln 1 x Ln 2) $_____

Annual Charges

4. Rate of Return and Income Taxes (RIT x Ln 3) $_____

5. Depreciation (Ln 1 x ____%) $_____

6. Maintenance $_____

7. Commercial/Marketing $_____

8. Other taxes/other charges $_____

9a. General Administration Expenses: Direct $_____

9b. : Allocated $_____

10. Rate Making Adjustment $_____

11. TOTAL ANNUAL COSTS (Lns 4 through 10) $_____

APPENDIX B

RATE OF RETURN AND INCOME TAX FACTOR

$$RIT = \frac{R - IC - I(t_1 + t_2 - t_1t_2) - D(t_1 - t_1t_2)}{(1. - t_1 - t_2 + t_1t_2)\ (1. - \text{Depreciation Reserve})}$$

or

$$RIT = (R + T_1 + T_2) \div (1. - \text{Depreciation Reserve})$$

Where:

R = return [COM x (1 - Depreciation Reserve - Deferred Tax Reserve)]

T_1 = state taxes

T_2 = federal taxes

COM = cost of money (authorized or requested rate of return)

t_1 = state tax rate

t_2 = federal tax rate

I = interest [interest rate x debt ratio x(1-Depreciation Reserve-Deferred Tax Reserve).]

IC = investment tax credit (e.g. 10% ÷ product life)

D = difference between accelerated and straight line depreciation

Example: Rate of Return = 12%

COM = .12	Interest Rate = .08
IC = .00667	Debt Ratio = .45
D = .02523	Deferred Tax Reserve = .0906
t_1 = .105	Depreciation Reserve = .130
t_2 = .46	

Calculations

R = .12 x (1. - .130 - .0906) = .0935

I = .08 x .45 x (1. - .130 - .0906) = .0281

$t_1 + t_2 - t_1t_2$ = .105 + .46 - .105 x .46 = .5167

$t_1 - t_1t_2$ = .105 - .105 x .46 = .0567.

$1. - t_1 - t_2 + t_1t_2$ = 1. - .105 - .46 + .105 x .46 = .4833

$$RIT = \frac{.0935 - .00667 - .0281 \times .5167 - .02523 \times .0567}{.4833 \times (1. - .130)}$$

RIT = .1686

PRIVATE LINE SERVICE

ATTACHMENT 1

Page 1 of 3

	PRODUCT LINE/ SERIES TYPE	DESCRIPTION
1.	1001	Metering, Burglar, and Fire alarm circuits; 30 baud; requires facilities arranged in parallel.
2.	1009A	Metering, Burglar, and Fire alarm circuits; 30 baud; requires metallic facilities arranged in parallel with DC continuity.
3.	1009B	Metering, Burglar, and Fire alarm circuits; 30 baud; requires metallic facilities arranged in series with DC continuity.
4.	1009C	Metering, Burglar, and Fire alarm circuits; 15 baud; requires facilities arranged in series.
5.	1002	Remote Metering, Teletypewriter, Teletypesetter, and Data circuits transmitting at rates from 75 to 150 baud.
6.	1005	Remote Metering, Teletypewriter, Teletypesetter, and Data circuits transmitting at rates from 75 to 150 baud.
7.	1006	Remote Metering, Teletypewriter, Teletypesetter, and Data circuits transmitting at rates greater than or equal to 150 baud.
8.	2001	Private Line Telephone.
9.	2002	Mobile Radio Telephone
10.	3001	Remote Metering, supervisory control, miscellaneous signalling, two-way and one-way audio tone protective relaying.
11.	3002 - A	Voice grade - data - two point.
12.	3002 - B	Voice grade - data - multi-point.

PRIVATE LINE SERVICE

ATTACHMENT 1

Page 2 of 3

	PRODUCT LINE/ SERIES TYPE	DESCRIPTION
13.	3002 - C	Voice grade - data - Bridged Alarm.
13-5	3009	Voice grade - Alarm Circuit.
14.	3040	Dataphone Select-A-Station; two-wire station channel (to protected premises).
15.	3041A	Dataphone Select-A-Station; four-wire trunk channel (primary link to alarm central station).
16.	3041B	Dataphone Select-A-Station; four-wire connecting channel (secondary link to alarm central station).
17.	3041C	Dataphone Select-A-Station; four-wire, polling station channel (to protected premises).
18.	60	Audio: Two point. Unidirectional effective two-wire audio service which is nonequalized.
19.	61	Audio: Two point. Unidirectional effective two-wire audio service. 100 to 5000 Hz.
20.	62	Audio: Two point. Unidirectional effective two-wire audio service. 50 to 8000 Hz.
21.	63	Audio: Two point. Unidirectional effective two-wire audio service. 50 to 15,000 Hz.
22.	70	Wired music: Unidirectional two-wire local channel without equalization.
23.	71	Wired music: Unidirectional two-wire local channel. 50 to 5000 Hz.
24.	72	Wired music: Unidirectional two-wire local channel. 50 to 8000 Hz.

PRIVATE LINE SERVICE

ATTACHMENT 1

Page 3 of 3

	PRODUCT LINE/ SERIES TYPE	DESCRIPTION
25.	80/82	Local Area Data Channel: Two point, two-wire.
26.	2 - Port A	Off Premises PBX Station with loop resistance of 0-199 ohms.
27.	2 - Port B	Off Premises PBX Station with loop resistance of 200-899 ohms.
28.	2 - Port C	Off Premises PBX Station with loop resistance of 900 ohms or more.
29.	2A	Off Premises CTX Station.
30.	4	Tie Line PBX to PBX.
31.	4A	Tie Line PBX to CTX.
32.	4B	Tie Line CTX to CTX.
33.	6	Off Premises Extension (non PBX).
34.	6A	Telephone Answering Service Line not terminating in concentrators.
35.	6B	Patron Line for Telephone Answering Service terminating in concentrator (concentrator located in CO).
36.	7	Concentrator Identifier Trunk for Telephone Answering Service (concentrator located in CO).
37.	27B	Patron Line for Telephone Answering Service terminating in concentrator (concentrator not located in CO).
38.	29	Concentrator Identifier Trunk for Telephone Answering Service (concentrator not located in CO).

PRIVATE LINE SERVICE

ATTACHMENT 2

PRIVATE LINE COST ELEMENTS

The basic cost elements to be studied are as follows:

1. Loops (see Attachment 3, "Service Offering Groups for Loop Study").
2. Bridging function.
3. Signalling.
4. Channel terminations, disaggregated on the basis of length of interexchange channel mileage.
5. Conditioning (nonrecurring cost element only).
6. Interoffice trunk equipment and facilities on a service specific basis recognizing the specific characteristics of multipoint circuits.
7. Interexchange equipment and facilities using switched network route-to-air mileage ratio unless a more or less direct routing is required for the generic type of service.
8. Service Area Transmission (SAT).
   a. Assigned on service specific basis using service specific loop lengths.
   b. Station SAT and central office SAT.

PRIVATE LINE SERVICE

ATTACHMENT 3

SERVICE OFFERING GROUPS FOR LOOP STUDY

1.	1009A, 1009B, 3002C 1009C, 3001, 3009	METERING, BURGLAR, FIRE ALARM SEPARATED INTO CENTRAL STATION LINES AND PATRON LOOPS
2.	6a, 7, 29, 27B	TELEPHONE ANSWERING SERVICE
3.	SPECIAL SIGNALLING SUBVOICE VOICEGRADE OTHER	EXCLUDES 1009A, 1009B, 3002C 1009C, 3001, 3009, 1001
4.	EXCHANGE RELATED PRIVATE LINE	EXCLUDES 6A, 7, 29, 27B, 2A
5.	RESIDENCE	
6.	BUSINESS	INCLUDES 6
7.	CENTREX CO	2A INCLUDED

OPINION ON REVISED COSTING PROCEDURES

In Decision (D.) 93367 issued August 4, 1981 in these proceedings, the Commission found there were substantial weaknesses in the costing methods used by The Pacific Telephone and Telegraph Company (Pacific) to support its rate design proposals. Consequently, the Commission ordered further hearings to review and determine equitable costing procedures. Those hearings have been held. At their conclusion, because of the complexities of the issues involved, the parties participating in this phase of the proceeding agreed to a special, seven-step procedure for bringing the issues to the Commission for decision. Under that procedure, (1) each party presented the assigned administrative law judge (ALJ) with a list of major issues, (2) the ALJ combined them into a single list, (3) the parties briefed their positions on those issues, (4) by a ruling, the ALJ gave his position on the issues and how they should be addressed in the cost studies, (5) the parties then held a series of meetings under the aegis of the Commission staff (staff) to develop as near as possible a concensus on the procedures to be adopted, (6) the staff gave the recommended procedures to the ALJ who reviewed them and made his final recommendation to the Commission November 10, 1982, and, (7) the parties filed exceptions to the ALJ proposal on December 13, 1982. Exceptions to the ALJ proposal were filed by Pacific, staff, Telephone Answering Services of California (TASC), General Telephone Company of California (General), Western Burglar and Fire Alarm Association (WBFA), and, collectively, The American Broadcasting Companies, Inc., CBS Inc., the California Retailers Association, and the Tele-Communications Association (Users Group). Our discussion will generally follow the subject matter in the form and sequence presented by the ALJ with the exception of some general comments offered by Pacific.

Pacific's General Comments

Pacific expresses great concern that if the Commission were to adopt the cost procedures recommended by the ALJ, the Commission would not be able to determine whether the revenues generated by a particular product line or service would be sufficient to cover the costs associated with such product line or service. Any deficiency in revenues for a given product line or service must be provided by another product line or service or by the residual ratepayers. Pacific claims that adoption of the ALJ recommendation will result in costs that do not match back to book totals, particularly in the area of investment and depreciation. This is because the method proposed by the ALJ for development of the depreciated investment factor understates Pacific's net book investment for particular product lines and services. And, indeed, Pacific is correct, but the ALJ's proposal faces up to a problem that has plagued the entire scheme of cost development and rate setting procedures used in past proceedings. That problem is what appears to be a rather substantial amount of stranded investment[1] in Pacific's books of account, an undepreciated investment that will continue on the books and, unless something is done to change depreciation practices, just get larger and larger. If the adoption of the ALJ's recommendations will bring that stranded investment into focus, then so be it, and the sooner the better.

This record is replete with examples of how and why the stranded investment got there; in the main, it is probably because we have failed to write off equipment at proper depreciation rates; some of it may be due to the so-called migration strategy. Because of the accounting methods we use, equipment retired before we expected it would be retired leaves part of its investment to be picked up by depreciation on other equipment still in service. In Exhibit 480, Users Group witness Selwyn gave a simple but telling example of how

[1] Pacific prefers to call it a reserve deficiency.

O R D E R

IT IS ORDERED that:

1. Telephone utilities subject to this Commission shall use the costing procedures contained in Attachments A and B in support of rates for the provision of telephone services and equipment under the jurisdiction of this Commission.

2. The first application of the costing procedures adopted by this decision may be made in any ongoing major rate case of the utilities or in the next major rate case NOI of the utilities, tendered after June 30, 1983. This order is effective today.

Dated APR 6 1983 . at San Francisco, California.

LEONARD M. GRIMES, JR.
President
VICTOR CALVO
PRISCILLA C. GREW
DONALD VIAL
Commissioners